by Alan Friedman

Estate Planning: Death Without Taxation

Death and taxes may be the only certainties in life, but they're the last things that any of us want to confront—especially at the same time. Add the volatile topics of money, family relations, retirement, business succession and the unpredictable future, and you've got a recipe for the financial disaster of a family legacy. The demise of family fortunes is not only commonplace, it's bloody as well. Even when family members muster up the energy to do the loathsome task of "estate planning," mistakes or omissions can be literal time bombs, ticking quietly before they explode.

Many business owners view taxes as the culprit stealing their family's wealth. Just listen to political rhetoric, business news and promises made (and broken) in presidential debates—legislation to cut taxes on the transfer of small business is always on Washington's table. But estate taxes really aren't the primary problem. The demise of a small business upon the death of its owner has more to do with poor planning than taxes.

Business owners aren't exactly blind to this problem. Even when business is good, owners often worry about how to transfer their company. But while they may lose some sleep, few get around to acting on those worries. So let's first take a look at why these smart entrepreneurs often ignore these critical business issues. Then we'll discuss some of the pitfalls in the transfer of a business to the next generation of family members. Finally, we'll highlight some estate planning tips that can leave your business in tact as it gets handed down, allowing you to take a long and restful, uh, nap.

Small Business, Big Problem

Here are some interesting, yet troubling, statistics about small businesses in the United States:

- Ninety percent of all U.S. businesses are closely-held family businesses, as opposed to large conglomerates and publicly-traded companies. The vast majority of them have fewer than 20 employees.
- Small businesses produce 39 percent of the Gross National Product, and provide more than half of the nation's technical innovations.
- There are more than 20 million small businesses in the American economy, employing two out of every three taxpayers. Approximately 14 million of these businesses are family-owned.
- Seventy percent of these businesses will fail to make the transition to a second generation of family ownership. Of those that do, less than half will make it to the third.

The reason why many family businesses fail to transfer from one generation to the next is sub-

ject to great debate. The 600,000-member National Federation of Independent Business (NFIB) blames the loss of family-owned companies squarely on the estate tax. They've been pushing—along with similar efforts from our own NAMM trade association—for federal legislation to phaseout and eliminate the estate tax, commonly referred to as the "death tax." The NFIB estimates that estate taxes force the sale of 87 percent of all family businesses before they make it to a third generation.

The group's figures aren't universally accepted, however. The most frequently cited figure on the tax's impact is that only 2 percent of all estates are subject to the estate tax. But that's all estates, and not all estates have a family business in them. Of the 2 percent that are paying taxes, we suspect a high percentage contain a closely-held business. Under any assessment, estate taxes arising from the lack of planning can financially cripple or ruin a business and cause heartache and hardship to the heirs of the decedent. Talk about rolling over in the grave—it's more like the Maytag spin cycle.

The Terms of Planning

The terms "estate planning" and "succession planning" often tend to be used synonymously, but they are two distinctly different processes. Succession planning is the process of resolving issues related to transferring management and leadership of a business. Estate planning is the process of resolving issues related to transferring business—as well as other—assets and ownership, minimizing taxes in the process. To do it right, you can't do one without the other.

Accordingly, the rest of this article will first deal with issues related to estate taxes, and end up with a few comments on succession planning.

Taxed to (and at) Death

It's really no wonder that nobody wants to deal with estate and succession planning. It's scary to talk about the eventual death of a loved one; estate and gift tax rules are complicated; the planning is based on the legality of wills, trusts and other documents that make the whole process error-prone; and it forces you to deal with the management capability (or lack thereof) of family members. To many, this process seems like a no-win situation, but that's not true. If you don't address these issues through proper planning, someone will win—the Internal Revenue Service (cue the scary music).

Under current law, every individual taxpayer gets a one-time $675,000 reduction in calculating the value of their taxable estate. This estate tax exemption is also known as the "unified estate and gift tax credit." Using this credit with proper estate planning and titling of assets, married couples can leave their heirs as a much as $1.35 million estate-tax-free. Above that, however, assets can be taxed at a rate as high as 55 percent. For example, if a business owner dies with a company and other assets worth $3 million, but without an estate plan and sufficient cash, the heirs could be forced to borrow heavily or sell the business to pay a $1 million tax bill.

Furthermore, a comprehensive valuation of an owner's business must be conducted, prepared and included with the filing of the estate tax return upon their death or a gift tax return if the owner gifts the shares during their lifetime. However, trying to determine the value of a closely-held business is anything but easy—especially for music product retailers.

Why? First, there's very little market data published on the purchase or sale of music retailers. Although there's financial data available on Guitar Center, the industry's one publicly-held company, I think it's safe to say that 99.9 percent of all retailers can't be compared to G.C. for valuation purposes. Second, the typical music retailer is somewhat unique from other retailing businesses—not only do music retailers sell stuff, they also conduct rental, service, repair, delivery and teaching activities. Finally, most music retailers can't demonstrate value based on their net income, because it's so low compared to the amount invested in the business. [For more insight on the magnitude of this dilemma, see the two-part *Think Tank* on business valuations that appeared in the July and August, 2000 issues of Music Inc.] What you'll quickly discover is that this highly subjective valuation process can have a significant impact on the amount of gift and/or estate taxes that are paid when the business passes from owner to heirs.

How Uncle Sam Spells Relief

The 1997 Taxpayer Relief Act provided some estate tax relief, but not as much as you might think. Yes, the estate tax exemption will increase from the current $675,000 to $1 million in 2006. Big deal (intended sarcastically)—so will the value of your taxable estate due to asset appreciation. And, yes, Uncle Sammy did include some estate tax relief for family-owned businesses. But like the rest of our tax law, there's a whole bunch of conditions that must be met that will make you wonder whether this really spells relief. The following is a brief synopsis of this very complicated segment of our current estate tax law:

Qualified Family Owned Business Interests (QFOBI) can exempt up to $1.3 million in assets from estate taxes. What constitutes a QFOBI? First, the business must have its principal place of business in the United States, and cannot have been publicly traded for the last three years. Fifty percent of the business must be owned by one family, or 70 percent must be owned by two families, or 90 percent must be owned by three families.

In the latter two cases, the family of the decedent must own at least 30 percent of the business. The business cannot have an excess of 35 percent of its adjusted gross income in certain types of personal holding company income, rents, dividends, capital gains and other portfolio income. The business value

must exceed 50 percent of the decedent's adjusted gross estate. The business value is reduced to the extent the business holds passive assets, excess cash or marketable securities. The decedent or a family member must have owned and materially participated in the business for at least five of the eight years preceding the owner's death. After death, qualified family heirs must then materially participate in the business for at least five- out of every eight-year period. If the heir disposes of their business interest, or ceases to materially participate in the business, the estate tax that would have been due at the decedent's death is now recaptured.

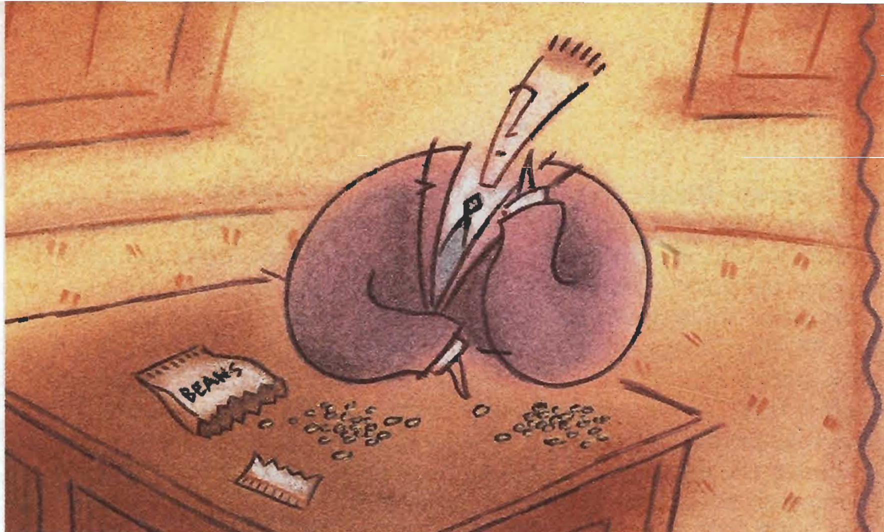
You've got to be kidding! Needless to say, you should always seek competent tax and legal advice in your quest for estate tax planning services.

Hey Boss—The Plan, The Plan!

Tattoo was right. Keeping a family-owned business family owned requires developing a written succession plan—one that should be developed early in a business owner's career. A lot of owners think that when they're ready to retire they can bring someone in to run the company. But grooming someone to take over a business can easily take five to 10 years. And don't assume that an heir is apparent. Ask yourself, "If I die tomorrow, who would be able to best manage my business without skipping a beat?" Perhaps it's an employee, and not a son or daughter.

Developing a succession plan early on gives everyone, including heirs, employees, customers, suppliers, bankers and other financial advisors time to offer their advice and thoughts. With that in mind, here are some specific tips to take into account while formulating your succession plan:

• Don't deny your own mortality. Many business owners start off conversations with "If I die." It isn't if, it's when. Sooner or later, we'll all go to the great sales floor in the sky. You don't want the transferring of your business resolved in the back



of a funeral home. No one said it's easy to talk about death, but keep in mind that by doing so you are protecting your family and its ability to financially survive when you go.

• Avoid the King Solomon pitfall. Although I like to see heirs treated equally, blindly dividing a business equally among heirs is asking for trouble. If one heir is clearly better at management, consider leaving nonbusiness assets—such as cash, jewelry, real estate and your '57 gold-top Les Paul—to other heirs in order to create a sense of equality. And don't assume your heirs even want the business. Your seven-day-a-week retail grind may not be the work lifestyle that appeals to your kids.

• Consider outside management. If the heirs are too young or inexperienced, think about bringing in professional interim managers. They can train family members in their new management roles.

• Coordinate technical or complicated stuff. Make sure shareholder agreements and corporate bylaws are in place and up to date. Don't forget buy-sell agreements in case one family member wants to sell out. Address other issues like personal guarantees on business loans, offering shares of stock to other family members and any other issue that can or will arise upon an owner's death.

• Be realistic. When you talk about the future of your business, be careful when making the promise "someday, this will be all yours." You may have never anticipated that the business needed to be sold when you made that promise. And make sure you revisit your plan to make changes as life-altering events happen.

Some Final Thoughts

When seeking professional estate planning help, be prepared for some sticker shock. A team including an estate planning attorney, a CPA, an insurance agent, a business valuation expert and maybe even a family counselor should design estate and succession plans. Accordingly, you'll find the combined cost for these services can run from $5,000 to $50,000 and can take six months to a year to complete.

To further support the need for competent professional advice, consider these two startling facts: (1) Estate and gift tax returns—especially those with a business reported in them—have the highest incidence of audit. Why? It's the government's last chance to grab some big dollars from taxpayers. (2) The highest incidence of malpractice suits against attorneys is related to estate planning services. Why? Once a mistake is made in an estate planning legal document, you can't undue it—it's been cast in stone by the event of death.

You may not be able to escape death and taxes, but with proper estate tax and succession planning you can certainly minimize one while they try to cryogenically fix the other.

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