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Lane Gorman Trubitt, PLLC
Accountants & Advisors

Your Accounting for a New Economy

Historic Tax Legislation Impacts Exit, Estate and Gift Considerations

On December 17, 2010, President Obama signed into law the Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010. For the next two years, 2011 and 2012, the gift, estate and generation skipping (GST) tax exemptions are unified, with the exemption set at \$5 million and the tax rate at 35%.

It is important to remember that these changes are effective only for the next two years. On January 1, 2013, if Congress fails to act, the estate, gift and GST exemptions will be \$1 million (adjusted for inflation) and the top tax rate will be 55%.

Estate tax exemptions are now portable. The executor of an estate may elect, on a timely filed estate tax return, to transfer any unused exemption to the surviving spouse. Despite the simplicity of portability, there are strong reasons to continue to use credit shelter trust planning, which include the following:

- Asset protection for the surviving spouse.
- Deceased spouse's unused exemption will be lost if the surviving spouse remarries and survives next spouse.
- Appreciation of assets excluded from surviving spouse's gross estate.
- No portability of deceased spouse's unused GST exemption.
- Assets in a credit shelter trust are managed and distributed in accordance with the wishes of the deceased.

President Obama's 2012 budget proposals include permanent estate and gift tax reforms, which include the following:

- Restoring the 2009 estate, gift and GST tax rules on January 1, 2013. These would include a top estate, gift and GST tax rate of 45%, a \$1 million gift tax exemption and a \$3.5 million estate and GST exemption.
- Make portability of the deceased spousal unused exemption amount permanent.
- Beneficiaries receive a step-up in basis of inherited assets.
- Expansion of regulations to ignore the use of valuation discounts on business entities.

Given the impact of recent and continuing economic conditions on the market as a whole and the decrease in value of many companies, now is the time to consider a company valuation in conjunction with exit, gift and estate tax planning.

Many companies are closely-held, family-owned businesses. As owners approach retirement age and older, there becomes a need for exit planning to both insure an orderly transition and to minimize gift and estate taxes.

Gifts of an interest in a closely-held, family-owned business to the next generation accomplishes two goals. First, use of the annual and lifetime gift exclusions to transfer a business interest to heirs with no gift or estate tax consequences. Second, by transferring the interest in the business, future appreciation in the gifted interest is removed from the donor's estate.

The economy and business conditions have not been kind. Contracts and profits are as low as they have been in recent history. This translates into lower overall company values. When values are low, a larger interest in the business may be gifted without paying gift taxes.

When valuing an interest in a closely-held, family-owned business for gift and estate tax purposes, IRS regulations require an independent valuation of the company by a business valuation analyst to determine the value of the interest being gifted. The valuation analyst must be credentialed by the American Institute of Certified Public Accountants, the National Association of Certified Valuation analyst or other qualified organization. The valuation report will be attached to the gift or estate tax return that is filed with the IRS.

In performing the valuation of a business, premiums and/or discounts will generally be applied to the estimate of value. For gift and estate tax purposes, fair market value must be used as the standard of value. If a minority interest is being gifted, a minority interest discount will be applied. A discount for lack of marketability is taken when valuing closely-held businesses.

For the majority of business owners, the business constitutes their largest asset, albeit illiquid. Given the current environment of low company values and the continued availability of discounts, steps should be taken to evaluate exit, estate and gift plans to take advantage of the current window of opportunity.