Taxes, Taxes Everywhere

By Brian T. Whitlock

Every time an asset moves from one person to another, there is the potential for one or more tax. Regardless of whether the persons are individuals or entities, the movement of cash and/or property may be subject to one or more of the following taxes: federal and state income tax, federal and state payroll tax, gift tax, estate tax, excise tax, sales or use tax, or in some jurisdictions, lease taxes. Navigating the ever changing seas of taxation can be a fascinating challenge, but it is especially true in succession planning.

The Golden Rules

Who is our client? Hopefully, we have been asked to represent the patriarch or matriarch and not one of the children or a member of “generation next.” Why? The reason is simple. It is the “Golden Rules”—“He who has the gold makes the rules.” Thirty-five years of experience in both law and public accounting has taught me that if we do not represent a motivated patriarch or matriarch as our client, nothing will happen. Countless chargeable hours will be generated and then written off, as nonbillable, if we represent “generation next” in their quest to get us to motivate mom or dad to make transfers.

The objectives of the senior generation, not the junior generation, drive the succession planning process. If we fail to understand the objectives of the senior generation, if we fail to tailor the plan to address the hopes, dreams and concerns of the senior generation, then they will procrastinate and withdraw from the planning process. We will be doomed to fail. The objectives of the patriarch or matriarch will dictate the scope and the success of the plan.

Identifying Our Client’s Objectives

Succession planning for family business owners is similar to building a traditional picture puzzle. There are hundreds of pieces that need to be assembled. Before we start building the puzzle, we need a clear vision and an understanding of the end game. What does the picture on the puzzle box look like? What does our client want the outcome to look like?

A lengthy discussion with the patriarch or matriarch about their objectives, their hopes and dreams for themselves, their business and their kids should
precede any attempt to recommend ideas, planning tools or transfer techniques. Exploring the clients’ fears and family experience of transfers in prior generations should reveal potential traps and pitfalls. The patient planner, which understands their client, and the client’s history will avoid the embarrassment of recommending a failed strategy that was used by the client or previous generations.

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Minimizing Taxable Transfers

Once the client’s objectives are clearly identified and the goals are firmly established, tax planning can begin. First, we should map out where the assets are now, and where they need to be at the end of the plan. Second, we need to identify all of the potential areas for tax. Each potential movement of an asset carries with it one or more taxes. Each tax that is paid diverts a portion of the available cash flow to the government and away from satisfying our goals. Each tax represents an obstacle, the goal is to navigate over or around the obstacles and craft a plan that minimizes the number of taxable transfers and maximizes the utilization of exclusions and credits in order to avoid or reduce tax.

The use of Limited Liability Companies (LLCs) and limited partnerships to hold income-producing capital assets permits equity to be fractionalized and shared with family members, without creating an entity-level tax.

The use of Grantor Type Trusts (described in Sections 671 through 679 of the Code) and other disregarded entities can allow the transferor to create an environment within which assets can be transferred without triggering an income tax (on a sale or an exchange) or a gift tax.

The use of flow-through entities such as partnerships (taxed under Subchapter K) and corporations (taxed under Subchapter S) eliminates the double taxation of earnings and avoids entity-level taxation of any gain arising from the sale of assets. Converting an existing business at the outset of an engagement from C corporation status to S corporation status may allow us to avoid double taxation of income, provide an opportunity to reduce payroll taxes and free up cash flow for other purposes.

S corporations currently allow income earned by the entity that is in excess of reasonable minimum compensation to avoid payroll taxes. Payroll taxes, such as Federal Insurance Contributions Act (FICA) (12.6 percent combined for employer and employee), Medicare taxes (2.9 percent combined for employer and employee), Additional Medicare Tax (0.9 percent for the employee) and Federal and State Unemployment Tax, can combine to exceed 15 percent and may approach as much as 20 percent. The use of flow-through entities will allow the patriarch and matriarch to retain access to the entity cash flow even as their active participation in the business diminishes. However, there are costs to relying on flow-through income. First, the 3.8-percent Net Investment Income Tax (NIIT) may kick in when the material participation standards can no longer be met. Second, tying the income to keeping the equity ownership in the business may inhibit the ability to

This type of discussion may appear to be frustrating for some tax practitioners. Business school and law school curriculums do not contain psychology courses. This type of discussion is really more reflective of the art of salesmanship. I was fortunate to learn at the feet of a master, Irving L. Blackman. Irv is currently 88 years young, and he is still selling. By background, Irv is a certified public accountant, but he also has a law degree. He was one of the founding partners in the Chicago-certified public accounting firm that I worked in for over 25 years. Irv has always been a great marketer. He has written numerous books over the years on the taxation of closely-held businesses and their stakeholders. The most important skill that Irv taught me was to listen to our client. Listening is a skill that should not be overlooked.

In order to effectively listen, we might need to ask some very open-ended questions about how our client got started in business. How did they come to be the owner or controlling shareholder? Did they start the business from scratch? Did they buy the business from someone else? What mistakes did they make along the way? What regrets do they have? What are the hopes and dreams that they have for the business? Probing questions may be necessary as well. Do they want to receive cash, either up front or, over some period of time in order to support lifestyle demands? If they make transfers of assets, how much control would they like to retain? Which members of the next generation will be actively involved in the operation of the business? Identifying our client’s objectives up front will help us to map out a strategy for getting there. Understanding the path that our client has taken to get to this point will help us understand his or her fears and hopefully permit us to avoid repeating past mistakes. Most entrepreneurs love the opportunity to tell their story, if someone is willing to listen.
transfer the equity for fear that it will reduce or cut off the access to the cash flow.

In order to avoid this obstacle, the planner may need to consider strategies that will allow the business to distribute cash through the payment of nonqualified deferred compensation, rents and royalties, and certain fringe benefits (e.g., health insurance, the payment of nondeductible club dues, etc.) may reduce and sometimes completely avoid payroll taxes.

Maximizing the Utilization of Exclusions and Credits

Most of the chapters of the Code contain sections that list exclusions, deductions and credits. The exclusions are often overlooked. Practitioners and clients are frequently drawn to deductions and credits in their attempts to reduce tax. “Tax simplification” in the income tax arena has led Congress to limit the utilization of income tax deductions and credits through the passage of phase-outs and income limitations. I would suggest that the exclusion provisions of the Code are the most powerful tools in the tax planner’s arsenal. Exclusions are not limited, phased out or diminished; the excluded income or asset was never “in” to begin with.

Chapter 1, Part III of the Income Tax, proudly lists some 40 items that are excluded from gross income in Code Secs. 101 through 140. Chapter 12, the Gift Tax, limits its exclusions to one section of the Code, Code Sec. 2503. Chapter 21, the Federal Insurance Contributions Act, carefully disguises and hides its exclusions throughout Section 3121 of the Code. It takes a keen eye and careful reading to find them.

Think about it:

- Life insurance proceeds, if properly structured, can be excluded from income tax and estate tax.
- Corporate death benefits can be excluded from estate tax.
- Deferred compensation can be excluded from payroll taxes.
- Donors can give an unlimited number of annual exclusion gifts of $14,000 per person per year.

The comprehensive transfer plan should endeavor to maximize the utilization of exclusions and credits. It seems like an obvious answer, but if that is the case, why are annual gift tax exclusions wasted? Why are these exclusions unused? The answer, I think can be found in understanding our client. What stops them from giving something away? What is it about the transfer process that grinds to a halt?

The greatest obstacle to wealth transfer is fear. Fear paralyzes the client. Fear of running out of money. Fear of needing to depend on someone else. Fear of losing control. The secret of wealth transfer is transferring value below the thresholds for taxation, but at the same time keeping control. Impossible?

Transfer Value Keeps Control

Control can be manifest in a number of ways. In a business enterprise, control lies with the person who has voting control over the equity of the business.

The use of flow-through entities such as S corporations, LLCs and limited partnerships to hold both business and other income-producing capital assets permits the client and the tax planner to fractionalize the equity ownership of capital assets into voting and nonvoting units of equity and share both the current income and the future appreciation. The client can transfer nonvoting portions of the equity, while retaining voting control over the handling and investment of the assets within the entity.

Navigating our clients, aware of their fears, through troubled tax waters is what wealth transfer planning is all about.

Outside of the business environment, trusts offer us a wonderful transfer tool. Irrevocable Trusts have always been a foundational component of wealth transfer plans. Assets can be transferred away from the grantor (client) and yet still be subject to the control of the rules laid out by the client. The client cannot retain control by acting as the trustee or keeping the voting control over assets transferred to the trust, but clever attorneys over the years have showed us that through a carefully drafted document, numerous provisions can be included that will permit the client to quell many of their traditional fears regarding transfer.

Mr. D. Clifford Crummey with the aid of his attorney showed us in the 1960s that it was possible to make annual exclusion gifts to an irrevocable trust and still have them qualify for the present interest exclusion under Code Sec. 2503(b).

If the client does not mind paying tax on the income after the assets have been transferred to the irrevocable trust: (a) the client can retain the right to borrow from the
trust, without collateral or security, provided that adequate interest is paid on the loan; or (b) the client can retain the right to substitute assets of equal value for the assets that were originally transferred to the trust.

The spouse of the client can frequently serve as trustee, and the spouse can have access to the income and principal of the trust through trustee’s discretion so long as the discretion is limited to an ascertainable standard, as defined under Reg. §20.2041.2

Trust protectors and powers of appointment can be skillfully inserted in the trust document to not only provide the family the opportunity to correct unanticipated events such as out of order, deaths and divorce but also to give the beneficiaries the right to continue to use the trust document after the death of the grantors as an asset protection or generation-skipping tax vehicle.

Navigating our clients, aware of their fears, through troubled tax waters is our mission as tax professionals.

ENDNOTES

1. D.C. Crummey, CA-9, 68-2 USTC ¶12,541, 397 F2d 82.