FEUSA ISSUE BRIEF

What's Ahead for Family Firms and the Estate Tax?

Family Enterprise USA

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Background

The United States boasts 5.5 million family firms that, collectively, generate 57% of the nation's GDP and employ 63% of our workforce, making them the backbone and primary drivers of our economy. Of the Fortune 500 companies, 35% are family owned, as are 60% of public companies. Family business owners are patient, long-term investors; making a profit is important to them, but it is not the primary motivator. They make decisions with an eye toward creating stable companies and communities. As a result, they are valuable economic engines in a community, providing long-term employment for workers and strong vendor relationships for suppliers. Research shows that the leadership tenure in family firms is 4-5 times longer than in shareholder-controlled public companies, which further bolsters stability.

Based on solid values of integrity, innovation and tenacity, family firms are intrinsically strong corporate citizens. Studies show that family businesses are committed to their employees, and are slower to shrink their workforce during tough economic times, which also makes them an important buffer against unemployment and eases the strain on social services. Family businesses are intensively engaged in living their values; FEUSA's research indicates that 95% of family firms engage in philanthropy in their community.

Issue Overview

In addition to managing their operations through difficult economic times, family businesses are also constantly navigating emotional and challenging succession issues integral to the longevity of their business, and essential in preserving continuity and stability for employees from generation to generation.

Succession of leadership and ownership – while difficult for all businesses, family and non-family alike – should not disproportionately impact family enterprises, but it does. Even with extensive advance planning, family businesses can face dire and catastrophic business consequences – such as a forced-sale at less than optimal values and with significant tax consequences – due to the ever-changing and broadly applied federal estate tax laws. Simply put, in the context of family business, an unexpected death of a family matriarch or patriarch is not only a family tragedy, but it can also kill the family business. The federal estate tax can play a large part in this loss.

The as-applied reality of the federal estate tax on family businesses is compounded by the tremendous uncertainty that has surrounded the tax law for the last 10 years. Over the last decade, the federal estate tax has been manipulated by widely changing tax rates and exemptions – changes that make advance estate and succession planning for family businesses all the more challenging. With more dramatic changes to the federal estate tax law looming, and with the economic recovery still struggling to take hold, efforts must be made to solidify the foundation for future growth and succession of family businesses through a critical examination of the federal estate tax.

Current Law. For the past several years, the federal estate tax law has provided elevated exemptions and lower tax rates. The key provisions of current federal estate tax law, which sunsets on December 31, 2012, are as follows:

- $5.12 million gift and estate tax exemption indexed for inflation.
- $5.12 million Generation Skipping Tax ("GST") tax exemption indexed for inflation.
- 35% maximum, estate, gift and GST tax rates.
- For decedent's dying in 2011 and 2012, a surviving spouse may use the most recent deceased spouse's unused exemption amount ("portability").

If no new legislation is enacted prior to December 31, 2012, then the estate, gift and GST tax exemption revert back to $1 million, with maximum taxable rates of up to 60%.

Obama Proposal. The Obama Administration's Fiscal Year 2013 Revenue Proposal recommends the following changes to the current federal estate tax law:

- $3.5 million estate and GST tax exemption.
- $1 million gift tax exemption.
- 45% maximum estate, gift and GST tax rates.
- Portability to remain intact.
- Required consistency in reporting basis by transferee of property received either through a gift or devise, with information reported by the transferor.

- Valuation rules will be enacted to limit the ability to discount closely held entities for lack of marketability and lack of control.
- Require a minimum term of ten (10) years for grantor retained annuity trusts. The new proposals would also require the remainder interest to be more than zero in value.
- Require a trust to terminate if it has been in existence for 90 years, thus limiting the effectiveness of the GST tax exemption.
- Require inclusion of irrevocable trust assets in the estate of an individual who, for income tax purposes, is deemed to be the taxpayer of the irrevocable trust.

Repeal Proposals. One of the few bipartisan proposals dealing with the federal estate tax law was introduced by U.S. Rep. Kevin Brady (R–TX) on March 30, 2011. H.R. 1259, known as the "Death Tax Repeal Permanency Act of 2011," currently has 206 cosponsors in the U.S. House of Representatives (only 218 are needed to pass a bill). In order to garner bipartisan support, more Democrats, beyond the following three cosponsors, would need to be educated as to its importance:

- U.S. Rep. Dan Boren (D-OK)
- U.S. Rep. Mike Ross (D-AK)
- U.S. Rep. Sanford Bishop (D-GA)

H.R. 1259 is presently before the House Committee on Ways and Means and provides for the following, to be effective on the date of enactment:

- Repeal of federal estate tax.
- Repeal of the federal GST Tax.
- Make permanent the current $5 Million federal gift tax exemption, with taxes levied at a rate of 35% for transfers over $5 million.

The Senate counterpart to H.R. 1259 is S. 2242, which was introduced by Senator John Thune (R-SD). There are 36 current cosponsors to S. 2242, all of them Republicans.

Other Estate Tax Bills. U.S. Sen. Mark Udall (D-NM) introduced the American Family Farm and Ranchland Protection Act, which would help family farms and ranches permanently protect their lands for agricultural and conservation use by changing the estate tax code to incentivize permanently conserving the land under easement. Under current law, if a property is placed in a conservation easement, 40 percent of the value of the land can be exempted from the taxable estate, but the amount is capped at $500,000. Udall's bill would raise the exclusion rate to 50 percent of the total value and cap it to $5 million, giving families tax relief when they choose to preserve portions of their lands for agricultural and conservation use.

Other proposals include U.S. Rep. Shelley Berkley's (D-NV) legislation (H.R. 1757) to permanently extend the current law provisions of the estate tax - $5.12 million estate and gift tax exemption and a 35% maximum rate. That bill does not currently have any cosponsors.

Arguments for Repeal

The reasons cited for repeal on Capitol Hill are numerous. Here are a few identified by the sponsors of H.R. 1259.

- *Job Loss.* By inhibiting the transfer of family businesses from one generation to the next, the estate tax affects jobs and diminishes employment opportunities within those businesses that are subject to estate tax. According to numerous academic studies, family firms are slower to lay off employees during economic downturns because of their focus on long-term stability. A relucatance to layoff in economic downturns was also validated by FEUSA survey data.

- *Hurts Small Business Owners, Farmers and Ranchers.* The estate tax hurts families with small businesses and farmers by inhibiting their ability to transfer assets without imposing a second layer of taxes.

- *Punishes Prudent Investing.* The estate tax punishes families who prudently invest and accumulate wealth over the course of their lifetime, by subjecting them to taxes upon death. One of the hallmarks of family firms is they are patient, long-term investors; making a profit is important to them, but it is not the primary motivator. This is the same type of bias that punishes family firms who want to build retained earnings to weather economic downturns.

- *Double Taxation.* The estate tax subjects taxpayers and their beneficiaries to double taxation, by taxing the same assets first during life and again upon death.

In addition to these points, FEUSA also recognizes that the estate tax requires a misallocation of both human and financial resources. Family members' time and money is invested in planning and legal fees to navigate around the tax, and in insurance policies to cover any liabilities. So, while a small percentage of family businesses may be recorded by the IRS as having paid the estate tax, thousands more spend money on expensive and time-consuming planning to avoid it. Whether paying a tax directly or spending precious time and money to plan around one, the effect is constrained growth.

The Impact on Family Firms if Congress Does Not Act

The worst case scenario for family businesses is for Congress to do nothing and ignore the estate tax issue in 2012. Indeed, no action by Congress will be more detrimental than the enactment of any of the lesser-favored proposals being debated. For instance, if the current law "sunsets," family businesses will be limited to a $1 million estate and gift tax exemption and be subjected to increased estate and gift tax rates of 55% - and up to 60% for estates valued from $10 to $21 million.

Risk of Claw Back. There is also considerable uncertainty surrounding the application of any "claw back" penalty for gift and estate tax exemption. In other words, risk remains that if permissible gifts of up to $5 million are made prior to December 31, 2012, and no further action is taken to clarify the federal estate tax laws going forward, a decedent could be forced to incur an additional tax based upon the difference of the gifts made during life and the exemption level upon death. If this occurs, family businesses following the law and engaging in pro-active planning to preserve their operations could still face tax consequences that could undo important plans set in motion to ensure continuity in ownership and succession for their businesses.

Reduced Estate Tax Exemption – Impact on Stock Valuation and Liquidity. Reduction of the estate tax exemption below the current $5.12 million to the "do nothing" level of $1 million can also impact the liquidity of family businesses and valuation of closely held family stock.

For starters, any estate tax must be paid within nine (9) months of the date of death. If the decedent holds the stock of a closely held family business in his/her estate, and that stock is valued above $1 million, the Estate could be saddled with marginal tax rates of 41% - 60% just to maintain family ownership of the stock, with only a limited amount of time to achieve liquidity to pay the tax. In other circumstances, a family business may feel forced to "buy back" the stock so that family ownership can be maintained. This can create a cascading effect for the entire family if unfavorable valuations are obtained, all while causing a potential liquidity crisis for the business if the tax burden is too large.

Conclusion

In such a highly charged political environment, family businesses must advocate their unique position in the economy as job-creators, engines for economic growth, and community stabilizers. Success in this arena will bring two outcomes: family firms will not be disproportionately or unfairly impacted by any changes to the estate tax laws, and communities will be more secure because policies are helping their long-term survival.

In the meantime, family businesses should educate their Congressmen and Senators to become more knowledgeable on the subject and the potential ramifications of this sometimes devastating tax.

Rick Hurt, Jeffrey M. Gad, Drew LaGrande and Megan DeVault are with the law firm Akerman Senterfitt and were significant contributors to this FEUSA Issue Brief. They counsel family-owned businesses on matters integral to family enterprises, including litigation matters, tax planning, corporate governance, mergers and acquisitions and more.

Family Enterprise USA is a non-profit 501(C)(3) organization that educates the general public, policymakers and the media about the collective issues facing family enterprises and publicly promotes their contributions to the common good.

Disclaimer: As all business owners are aware, nothing is simple when it comes to taxes. This paper contains many general statements and simplifies complex concepts. There are many nuances in the issues discussed in this paper and exceptions to the general rules. A tax advisor should be consulted before taking any action with respect to a particular business or situation.