



Business and Succession Planning: Estate & Gift Tax Relief

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- A taxable gift is the amount that the value of the gift exceeds the annual exclusion amount year by year. (Currently, the annual exclusion is \$12,000 per person.)

- Estate and gift taxes have the potential to affect 5% of all estates in the United States. With estate and tax planning, only 2% of all estates can be subject to the estate tax. The new exclusion amounts decrease the likelihood that your estate or gifts will be taxed as long as you do some proper estate planning.

Introduction

We all know that whenever you pass wealth from one generation to the next, tax consequences can occur. For instance, if a father gives a gift of \$150,000 to his son to buy a home, there is a tax consequence for this money changing hands. However, the tax consequence may not be seen for many years to come, if ever (see The Unified Credit Below). In recent years, the threat of gift and estate taxes has been alleviated to some extent by automatic inflation indexing and some changes in the laws which give rise to the estate and gift taxes.

The Unified Credit

The Estate Tax Credit is called the "Unified Credit", because at one time, the taxable gift exclusion and the estate tax exclusion were the same amounts. The same is no longer true. A taxable gift is the amount that the value of the gift exceeds the annual exclusion amount year by year. (Currently, the annual exclusion is \$12,000 per person.) Taxable gifts are subject to a \$1,000,000 life time exclusion. This means that if a person gives taxable gifts in a lifetime of over \$1,000,000, that person will be required to begin paying taxes on

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A CASE STUDY

Circular Loans

A Circuit Court of Appeals has affirmed the Tax Court's holding that circular loans were did not increase each owner's bases. The result of the court decision meant the shareholders could not deduct losses which were desirable. In the case, three flow-through corporations were involved. Company #1

obtained a very sizeable loan. Company #1 loaned the money to Company #2. Company #2 loaned the money to Company #3. In time, Company #3 loaned the money back to Company #1. Because of the circular nature of this loan, the Courts ruled the upward adjustment in basis would not be allowed for loss purposes.

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such gifts. On the other hand, there is also an estate tax exclusion. Currently, if a person dies with an estate (plus taxable gifts) of over \$2,000,000, their estate is subject to taxes on the value of the estate plus taxable gifts exceeding \$2,000,000.

No Gift Taxes Owed

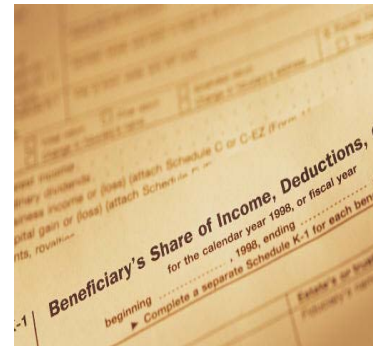
The IRS is likely to tell more people and estates in the coming years that no taxes are owed because the estate and gift tax exclusions are increasing each year.

For 2004 and 2005, the annual gift tax exclusion was \$11,000. This meant that if you gave a gift to anyone, the total amount of that gift for the year could not exceed \$11,000 or the gift could be a) subject to tax and b) the donor would be required to file a gift tax return. If the donor exceeded the \$11,000 per year amount to any one donee, the donor would then be said to have a taxable gift; and hence the taxpayer would then be required to file a tax return and reduce their \$1,000,000 lifetime gift tax exclusion by the amount of the taxable gift. The donor of the gift is generally the responsible party required to pay the gift taxes if any are due. There are only a small number of situations where donee are responsible for the taxes.

In 2006, the annual exclusion for the gift tax has been increased to \$12,000. The benefit of this is that now donors can give away more funds than in past and not be subject to any taxes or the requirement of a filing a gift tax return.

No Estate Taxes Owed

Another benefit of some rule changes is that the estate tax exclusion has also increased. Not too long ago, the estate tax exclusion was under \$1,000,000. In 2002 and 2003, the estate tax exclusion was under \$1,000,000. In 2002 and 2003, the estate tax exclusion was \$1,000,000.



In 2002 and 2003, the estate tax exclusion was \$1,000,000. In 2004 and 2005, the estate tax exclusion was increased to \$1,500,000. On January 1, 2006 the estate tax exclusion was increased to \$2,000,000. This current exclusion amount lasts until December 31, 2008. Then in 2009, the estate tax exclusion is scheduled to increase to \$3,500,000 per person.

Conclusion

Estate and gift taxes have the potential to affect 5% of all estates in the United States. With estate and tax planning, only 2% of all estates can be subject to the estate tax. The new exclusion amounts decrease the likelihood that your estate or gifts will be taxed as long as you do some proper estate planning. This is critical if you own a business and / or are involved in the ownership of real estate. Contact the professionals at The Center if you have any questions regarding estate and gift tax planning.

The Bradway Group—Tampa
1101 Channelside Drive, Suite 290
Tampa, FL 33602-3611

The Center For Financial, Legal & Tax Planning, Inc.
4501 W. DeYoung St., Suite 200
Marion, Illinois 62959

Editor's Comment:

S Corporation shareholders can only deduct losses to the extent of their bases in the company. Loans can increase that basis when needed. Loans to an S Corporation are investments only if there is an actual economic outlay and be at arm's length. The outlay must leave the person less wealthy. However, the substance of the transaction did not make the shareholders essentially less wealthy to amount to an economic outlay. Had the shareholders run this circle multiple times, their basis could have been potentially billions of dollars.

Common sense must be employed when doing tax planning. While this scheme was ingenious in the sense it increased basis on paper, it lacked substance and was not allowed. A better way of increasing basis in this case would have been to actually go to the bank and get a loan.

Furthermore, from a legal angle this transaction presented a large risk. Had one of the companies suffered a large tort judgment, this sham loan would have become a real asset subject to confiscation. Do not ignore legal angles when planning tax strategy.



**Avoiding Common Mistakes in M&A –
Client Confidentiality**

A nightmare scenario for most business owners is to learn that rumors are spreading among their employees, customers, vendors, bankers and competitors that their business is for sale.

It's only human nature for most people to suspect the worst until confronted with the truth, and we've all seen examples where long term, loyal employees start lining up & seriously considering their other employment options; long term, loyal customers begin qualifying back up sources "just in case;" vendors and bankers begin to reconsider if they might be over extended in the event of a sale; vendors' sales reps soon spread the rumor to all who'll listen, including your fiercest competitors; and competitors use the opportunity to undermine your customers' confidence that you will always be there when they need you, etc.

In short, there is enormous downside risk from leaking the news that you're thinking of selling, and almost no upside. For this reason, most thoughtful business owners entrust the marketing and sale of their business to an experienced intermediary who knows how to CONFIDENTIALLY market your business to the most likely and most qualified buyers, while screening out the nose tire kickers.

At The Bradway Group, we're in regular, direct communication with hundreds of qualified & motivated, individual and corporate buyers – both domestic and international – for small- to medium-sized companies. We're experienced in CONFIDENTIALLY finding just the right buyer for this sized business.

If you know of a business owner who's thinking of selling and who might benefit from a free consultation with us, have them contact me or any of the M&A professionals at www.bradwaygroup.com

Mike Ertel, CBI, M&AMI
The Bradway Group
813.299.7862 Direct
ertel@bradwaygroup.com

The Bradway Group—Tampa
1101 Channelside Drive, Suite 290
Tampa, FL 33602-3611

The Center For Financial, Legal & Tax Planning, Inc.
4501 W. DeYoung St., Suite 200
Marion, Illinois 62959

The Bradway Group—Palm Beach
824 US Highway 1, Suite 270
North Palm Beach, FL 33408
Phone: 561-776-8085
Fax: 561-776-1844

The Bradway Group—Tampa
1101 Channelside Drive, Suite 290
Tampa, FL 33602-3611
Phone: 813-864-6600
Fax: 813-864-6601

The Center For Financial, Legal & Tax Planning, Inc.
4501 W. DeYoung St., Suite 200
Marion, Illinois 62959
Phone: 618-997-3436
Fax: 618-997-8370

Satellite Office:
Longboat Key, FL 34228
Phone and Fax: 941-383-3338



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www.taxplanning.com

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▶▶▶ Frequently asked questions:

Q I have been operating a sole proprietorship for several years and filing a Schedule C. However, this past year I have not received any revenue or had any expenses. Is it necessary to file a Schedule C this year?

A: If your sole proprietorship is inactive for the entire past year, you do not have to file a Schedule C. All other business entities (S Corporations, C Corporations, etc..) would be well advised to file the appropriate forms as usual even if they have no business activity.

Q I have just started a business. There is no question regarding whether my business must pay federal taxes. How do I know if I am required to pay state taxes?

A: This question is a state tax question. As such, each individual state will have their own set of laws regarding whether a business must collect sales taxes, income taxes, and the like. Generalities can be made though. Generally if you make a profit, pay employees, or sell merchandise, your business is subject to state level taxes.

Q I just started a small business, and I was wondering if I have to file quarterly taxes.

A: As a self employed individual, you will need to determine whether the amount your business makes is higher than the amount allowed in order to not file quarterly taxes. If the amount is higher than allowed, quarterly tax payments will be required. Form 1040-ES will assist you in determining whether you should pay quarterly taxes or not.

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