Daniel M. Isard

Next in Line

Passing your firm on to the next generation requires analysis of the value of the business today and how much you'll need to be financially independent.

Dear Dan,
My present plan is to leave the firm to my child, who is licensed and really focused on helping me grow the business. I can remain the owner and pass it to her via my will, and I can keep taking a salary for my lifetime. I know that by doing this, I am building up my estate, but I understand there really is not a federal estate tax for most people anymore. So, Dan, is there anything wrong with this idea? By the way, this is exactly how I got the business from my father.
Signed, Runit Tilleye Dropover Jr.

Dear RTD2,
This question covers several points of cash flow and taxation, including corporate tax, income tax, gift tax and federal estate tax. I may even use it, along with my answer, as a submission for my master's thesis in taxation!

It should come as no surprise to you that just because your father passed the business to you in this way, it does not make it right. I'll begin by reminding you that since 1980, we've had more than 16 changes to the U.S. federal income, estate and gift laws, and most of them were aimed at eliminating every tax loophole your father employed. RTD2, let me strongly warn you that if you do this and get caught by an audit, you'll have a lot of feeble explaining to do to an unsympathetic judge at your sentencing hearing.

At this point, I'm going to assume that I have firmly convinced you to try something different and will now go on to establish some basic points about the tax code.

All compensation is not deductible. Only that which is reasonable, usual and customary for a funeral home is deductible. A clear example would be a funeral home owner who paid his 16-year-old kin $40,000 a year to mow the lawn. Once the owner got out of prison, it was clear to him that the compensation was more of a tax dodge than a reasonable compensation.

The same could be said in reverse. As you get older, for you to take compensation equal to what you get paid now is not necessarily reasonable. And it's not just due to your age but also if you plan to spend considerable time away from the funeral home. If compensation is found to be nondeductible by an audit, you are deemed to have taken a dividend of that amount.

Or what about the director who winters in a warm climate and takes a full salary all year long? When audited, the director claimed she goes to Florida to write preneed contracts. Even though there was no record of her ever writing a preneed contract nor any record of the effort she took to create a preneed lead system, rather than concede the point, she became more assertive with the auditor. She went so far as to tell the auditor that he could use her condo in Florida for a week if he let her off. Needless to say, bribery of a federal agent is frowned upon.

So, RTD2, can you stay on salary for the rest of your life? Sure you can, as long as you die before cutting back your working hours and effectiveness. Or be prepared for the compensation not to be deductible to the company.

If you do sell to your child, you have two options. You can carry back the note or you can get cashed out from a bank. The note carry-back is attractive to many people because the interest rate is typically higher than any reinvestment could yield in the present market. For example, if you carried back the note and got 6 percent interest, it's far better than selling out, losing 20 percent or more to taxes and having to reinvest the net amount at a 2 percent yield. The principal is taxed as a capital gain, so it's taxed at about 20 percent. This is akin to changing salary taxed at 35 percent for an income stream taxed at 20 percent. Interest would be taxed at ordinary income rates, but without much other income, that rate would be about 25 percent.

As for the transfer of the business, this would be at the value on the date of death. At that time, the business and real estate would be valued by a qualified appraiser. This includes real estate held outside of the company or within the company. Then the fun begins because the estate could stay open until the Internal Revenue Service signs off on matters. While there might not be a federal estate tax due, there are going to be possible state estate taxes and probate fees. These costs for wrapping up the estate, over time, can be very expensive.

As I mentioned, there have been changes in the federal estate tax since your father's death. The amount of the estate that is not subject to tax (the exclusion) has grown dramatically since 2000, going from $675,000 in 2001 to the present $5,430,000! Furthermore, the present amount is per married individual, so a husband can die and protect that amount, and a wife, upon her subsequent death, can exclude the same amount. Effectively, that means we have more than $10,860,000 that is exclusionary now. Therefore, the estate tax is not an issue unless you are in the top 1 percent of U.S. households. However, the big issue is getting the assets where you want them and to the person who can use them within the terms of control they need to have.

Filing a tax return, for income or estate tax, is not perfect. The IRS always has the right to review and question your deductions and tax calculations. This is called an audit. There is also a period of time after which it is assumed the tax filing is accepted as is, which is called the statute of limitations. A statute of limitations has a beginning date and an end date. For income tax, it begins when the tax return is filed, assuming the return is essentially correct, and is assumed to end three years from the filing date. But a tax return that misrepresents the tax due by more than 25 percent could be seven years, or in some cases, it could be deemed that it was never filed at all, in which case the statute of limitations doesn't even begin to tick off!

The statute of limitations for estate tax returns is also well spelled out. The return is due by the ninth month after Elder Dropover's passing, and the statute of limitations is three years from the date of the filing. So this would cover the estate tax return, but it would probably also trigger an income tax audit as well if Elder Dropover owned any shares of stock upon his death. When it comes to auditors, individual income tax auditors are usually the low-status auditors; corporate income tax auditors are higher up the ladder. The federal estate auditors are the top dogs. These auditors would undoubtedly bring any compensation paid to the Elder Dropover for the past three years back into the corporation's earnings, voiding the deduction for salary to your dad. If you are a C corporation, the corporation would then have to refile the return with three years of non-deductible payments, interest and penalties! If you are an S corporation, this would require the corporation and the estate of the shareholder to refile, which I'm sure would cause you to visit your father's grave in tears, but not for the right reason.

So, the solution is *not* to pay out salary forever and then transfer the stock by your will upon your death. The solution is to:

a. Value the business today.
b. Compute how much you need to be financially independent.
c. Transfer the business as part of meeting this financial independence.
d. Let the next generation make the decisions they need to make to operate the business in their style.

Allow me to give you an example. We recently had a family retain our services. They had a 150-call funeral home doing about $1 million in revenue. The husband and wife were ready to retire, and the child, probably your child's age, was ready to take over. The problem was that the parents had only saved $400,000, but they needed an income of about $120,000 a year.

We first analyzed and determined that their buying power of $120,000 annually would be increasing by about 2 percent per year. Based on their limited savings, they couldn't survive. However, with Social Security added to this, they would get about $50,000 a year. We proposed that the parents sell the business, which we had assessed at about $1.3 million. That didn't include the sale of the business real estate, which we advised the parents to keep for about 15 years and rent the property. This rental would give some additional revenue, even after paying the property mortgage off. Furthermore, the business could be sold for $1 million cash at closing by bringing in a third-party bank, and the business would pay a covenant not to compete to the parents for $30,000 a year for a decade. Now we were up to the amount they needed for their buying power.

The child can operate the business, and if he does a good job, his salary would go from about $65,000 a year to about $95,000 after paying off all debt service. So the child would win and the parents would have a lump sum of cash, so the chances of default are low. If a default does happen, the parents still own the real estate, which is their security.

So, RTD2, the better solution is not to do nothing but to retain some competent help and get a solid plan in place. Only then can each generation live long and prosper. ✶

Daniel Isard, MSFS, is president of The Foresight Companies LLC, a Phoenix-based business and management consulting firm specializing in mergers and acquisitions, valuations, accounting, financing and customer surveys. He is author of several books and host of The Dan Isard Show at www.funeralradio.com. *He can be reached at 800-426-0165 or danisard@f4sight.com. For copies of this article and other educational information, visit* www.f4sight.com. *Connect with Isard and The Foresight Companies by following them on Twitter at @f4sight or on Facebook.*

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