

Use Multiple Entities To Save Tax Dollars

We've met few business owners who believe they should pay more income taxes every year. Instead, most are frustrated with the inability to engage in meaningful income tax planning that *reduces* the annual tax bite. Take Thomas Lamplighter for example.

Thomas was a second-generation owner of a brickyard. His eventual Exit Planning objective was to pass the company to his children in a way that would avoid the gift and estate taxes he had to pay when his father had passed the business to him. But his children were still young and he first wished to provide them with the best possible education. Preferably, he wanted to find a way to have the business pay for his children's education, on a tax-deductible basis no less.

Thomas's fourteen year-old son, Thomas III, attended an expensive private school while his seventeen year-old daughter, Patricia, was not only in private high school but was looking forward to many years of higher education. Lamplighter's advisors suggested he create multiple business entities in order to distribute taxable income to the right owners (the kids) in the right amount and at the right time. How was Thomas able to accomplish income tax planning as well as estate tax planning through the use of multiple entities?

The answer is fairly simple. Thomas and his wife owned the land used in Thomas's business. His attorneys suggested that the Lamplighters transfer that real estate into a family LLC (Limited Liability Company), and gift a minority interest in that LLC to trusts created for the benefit of Thomas III, and Patricia. The LLC would then lease the land to the business, thereby insulating the land from the operational risks of the business. The LLC and the business would enter into a long-term lease thus providing income to the LLC.

To the extent the children owned interests in the LLC, they would receive, and be taxed on, income to extent of that year's earnings. The ownership interest would be gifted to the children, applying standard minority and lack of marketability discounts. This technique removes that share of the property from the Lamplighters' estates and more importantly, removes the future appreciation in the value of that real estate from their estates.



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Just as importantly, *the income attributable to the LLC interests owned by the children (through their trusts) would be taxed to the children in their own tax brackets*, since each child is at least 14 years old. Each child's ownership interest was calculated to produce approximately \$30,000 of taxable income each year. After paying taxes of approximately \$4,000 (an effective rate of less than 15 percent), each child has about \$25,000 to pay his or her education expenses or other expenses (such as vacation expenses) that would not be deemed "support obligations" of their parents. The tax savings to the senior Lamplighters are not inconsequential. An extra \$60,000 of income is removed from their marginal tax bracket. This removal results in tax savings of roughly 45 percent of \$60,000 or \$27,000.

If we subtract the taxes paid by the children (\$8,000) from the parents' tax savings, the entire Lamplighter family saves about \$20,000 per year in taxes. Expecting that the Lamplighter children will be in school for at least ten more years, Thomas concluded that the cumulative tax savings are not inconsequential — about \$200,000. At the same time, the Lamplighters have removed from their estate an asset that can be expected to grow in value. Finally, they have removed from their taxable income an income that they do not need personally.

The final result?

- Tax savings to the family of approximately \$20,000 per year
- Estate tax savings of an undetermined amount
- The creation of a creditor-protection vehicle (an LLC) to protect the real estate from attack by business creditors

The total cost in terms of on-going accounting and legal fees is less than \$1,000 per year in most circumstances. Not a bad return on investment! It is clearly necessary to consult with your Advisory Team, beginning with the financial professional who provided you this newsletter to see if this type of planning is appropriate for you, your family and your business.

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