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Estate Planning & Elder Law

Business Succession Planning in Distressed Times: An Opportune Time To Pass the Torch

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Believe it or not, there is a silver lining in today's economy when it comes to estate planning and particularly passing the family business to the next generation. The current economy notwithstanding, two primary reasons for business succession failure are lack of proper estate planning and that many business owners wait until death to transfer ownership of the family business to the younger generation at significant estate tax cost. As discussed below, the current environment of low interest rates, depressed asset values and valuation discounts make it an opportune time for senior owners of closely-held businesses to pass the torch to the younger generation at minimal transfer tax cost.

What Can You Do?

Interest rates are at historical lows. This offers the owner of a closely-held business an opportunity to make loans to a child or grandchild purchasing the business under terms the descendant may be able to afford. Typically, to structure a loan to a family member that meets IRS guidelines, the loan must bear interest at a rate which at least equals the monthly rate issued by the Internal Revenue Service, referred to as the Applicable Federal Rate or "AFR." The AFR for July 2009 for a note with a term of three years or less is only 0.82 percent. If the loan is 3-9 years, the AFR increases to 2.76 percent and for a loan of nine years or more, the AFR is 4.36 percent. Given these low AFR rates, family loans or sale of business interests pursuant to installment sales are ideal ways to transfer wealth and assets to the younger generation.

In the current distressed economic climate, it is possible to transfer assets, such as closely-held stock and real estate, to your children and grandchildren at the currently depressed values of the business assets. By transferring a business interest now to a child or grandchild at a depressed value, the future appreciation on the business interest can inure to the benefit of the younger generation with minimal or no gift or estate tax consequences.

Under current law, valuation discounts can be applied to the transfer of certain business interests. Generally, two types of discounts apply — a marketability discount because the business interest is not a publicly-traded asset; and a discount for minority interest or lack of control if the interest being gifted represents the nonvoting or noncontrolling interest in a company. Let's take an example: assume Dad and Mom own a printing business appraised at $3 million (including real estate and other business assets). Mom owns a 49 percent non-voting interest in the business and Dad owns a 1 percent voting interest and a 49 percent nonvoting interest. Mom can gift her 49 percent nonvoting interest to her children at a discounted value because the interest is a minority interest in a closely-held company that is not readily marketable when compared to assets that are publicly-traded. Discounts vary but generally range from 20 percent to 40 percent of the gross value of the asset. In the above example, if Mom gifts a 49 percent nonvoting interest to her children, the value of the gift without any discounting will be approximately $1,470,000 ($3,000,000 x 49 percent). Now assume a 35 percent discount applies because the interest being gifted represents a noncontrolling interest in a closely-held business. The value of the gift for gift tax purposes will be reduced to approximately $955,000 ($3,000,000 x 49 percent x 65 percent), a difference of approximately $515,000. With the current Federal estate tax rate at 45 percent on estates exceeding $3,500,000, the use of a

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valuation discount can result in substantial estate tax savings.

While valuation discounts are currently utilized in the estate planning arena, their existence may be fleeting. On January 9, a bill referred to as the "Pomeroy Bill" and previously known as the "Certain Estate Tax Relief Act of 2009" (HR 436) was introduced in the House of Representatives. This proposed legislation seeks to eliminate the use of valuation discounts in a closely-held company which holds nonbusiness assets (assets not used in an active trade or business). For example, any transfer of nonbusiness assets (stocks, bonds, real estate, etc.) would be valued without any valuation discounts. The proposed legislation also seeks to eliminate minority discounts that currently apply for transfers by a donor whose family members have control over the business even if the donor does not.

How Can You Do It?

Gifting: In 2009, the annual amount that each individual can gift to a donee, free of federal estate and gift tax, increased from $12,000 to $13,000. A husband and wife can make a joint gift of $26,000 without incurring a gift tax. For gifts exceeding the annual exclusion amount, an individual can gift up to $1,000,000 during life without paying any Federal gift tax (herein, the "Lifetime Gift Exemption"). The use of annual exclusion gifts and the Lifetime Gift Exemption, combined with valuation discounts, may allow an individual to transfer a substantial portion of his business interest to family members at minimal gift tax cost. Gifts of business interests can be made to children directly or to trusts established for the benefit of children and/or grandchildren.

If parents are concerned about outright gifts to children, a trust can be established to own the business interest. From a creditor perspective, any assets in the trust also will be protected from creditor claims of trust beneficiaries (i.e., the children) to the extent the assets in the trust are not distributed out to the beneficiaries. Further, if properly created, a trust can exist for multiple generations.

Sales to Family Member: As an alternative to a gift of the business interest, the business owner may consider the sale of the business interest to the junior generation with a promissory note. Unlike a commercial loan, the terms of an intrafamily promissory note can be structured to meet the specific needs and circumstances of a child or grandchild. For instance, the promissory note can provide for interest-only payments for the term of the note with a balloon principal payment paid at maturity. The sale of a parent's business interest to a child will provide a stream of income for the parent and enable the child to obtain an interest in the family business at a lower cost due to the current depressed value of assets and low interest rates. While the parent may realize capital gain on the sale of the business interest, the capital gains rate of 15 percent minimizes the tax hit when weighed against the value of the business interest that is removed from the donor's estate.

Sales to Intentionally Defective Grantor Trusts: In the current economic climate, selling a business interest to an intentionally defective grantor trust ("IDGT") is another attractive transfer technique. An IDGT is a trust under which the grantor is treated as the owner of trust assets for income tax purposes, but not for gift or estate tax purposes. Any transactions such as sales between a grantor and an IDGT are ignored for income tax purposes. Accordingly, the grantor parent will not recognize a capital gain on the sale of a business interest to an IDGT and any interest income paid on a promissory note will not produce taxable income to the grantor. The beneficiaries of an IDGT can be the grantor's children and grandchildren or even individuals who are not the grantor's lineal descendants but to whom the grantor wishes to leave the business. The business interest sold to the IDGT, together with all future appreciation in the value of the business, will be removed from the grantor's taxable estate and inure to the benefit of the IDGT beneficiaries.

Going back to the prior example, let's assume that Dad sells his 49 percent nonvoting interest in the family printing business, valued at $3 million, to an IDGT in exchange for a promissory note with a face value of $955,000, bearing interest at the appropriate AFR. The face value of the promissory note is based upon the appraised value of the 49 percent nonvoting interest utilizing a minority interest and lack of marketability discount of approximately 35 percent ($3,000,000 x 49 percent x 65 percent). Assuming this discount is accepted by the IRS, Dad will have transferred $1,470,000 worth of property (undiscounted) to his IDGT without utilizing any of his lifetime gift exemption. Since the IDGT is treated as a grantor trust for income tax purposes, no gain or loss will be recognized on the sale of Dad's 49 percent nonvoting interest in exchange for the promissory note. Further, no interest will be treated as paid on the promissory note during the term of the note and all items of income and deductions will flow through and be taxed to Dad as grantor, rather than the IDGT, for income tax purposes. With a sale to an IDGT, it is recommended that the IDGT should have sufficient assets of its own to make a down payment on the purchase of Dad's nonvoting interest. If the IDGT does not have sufficient assets, then prior to the sale, Dad should make a gift to the IDGT of assets that can be used to make the subsequent purchase of assets. Typically, a gift equal to at least 10 percent of the value of the assets transferred to the IDGT should be sufficient. ■