

The time is right for family equity transfers

When planning for the future transition of your business you have many options to consider, including taking advantage of estate planning strategies designed to transfer equity to your family in a tax efficient manner. Now may be the opportune time for you to move forward with such planning with historically low interest rates and high gift tax exemption amounts providing the absolute optimal conditions for transferring business ownership interests.

Why is estate tax planning so important for business owners

Depending upon the extent of your estate tax exposure you may have a silent partner in your business—the IRS for a 40% percent interest and at no risk! That's because the current federal estate tax rate is 40% with the estate tax payment generally due nine months after a business owner's death (or for married couples upon the death of the business owner and their spouse).

This estate tax account payable can be a huge contingent liability that if not strategically planned for can negatively impact the future viability of your business. And if you plan on selling your business in the future, not moving equity to the next generation will allow the IRS to share in a portion of the sales proceeds when those dollars are eventually taxed in your estate.

Conditions have never been better for estate tax reduction planning

Fortunately, at least for now, the federal estate and gift tax exemption amount has never been higher (around \$11.5 million per person or \$23 million for a married couple). So there is currently a great deal of flexibility to transfer equity in your business at no current tax cost. Many advanced estate tax planning strategies are also made even more effective in a low interest rate environment and these strategies are especially attractive now with the applicable interest rate under 2%.

Importantly, the current federal exemption amount is due to sunset at the end of 2025 and return to an inflation adjusted \$5 million in 2026. Don't take this timeline for granted, however, given the always changing political climate and ever increasing federal budget deficits. Also keep in mind how future appreciation in the value of your business may impact your potential estate tax exposure.

Valuation discounts for lifetime transfers of business interests

A compelling reason to make lifetime transfers of interests in your business is to take advantage of valuation discounts that will otherwise not apply if you sell your business or wait until death to transfer a 100% ownership interest to your family. Minority interest and lack of marketability discounts can substantially reduce the gift tax value for such transfers by oftentimes 30% or more getting you more bang for your buck from your exemption amount. Transferring nonvoting ownership interests may enhance the amount of the discount while also allowing you to retain complete management control of your business until you have put a leadership succession plan in place.

The benefits of using a trust for transfers of business interests

Many business owners utilize trusts for transfers of ownership interests to allow for multi-generational sheltering from the estate tax. Holding a transferred business interest in trust can also provide family members with a measure of creditor and divorce protection. If professional oversight of trust distributions and management of liquid investments (including any future business sales proceeds) is desired, then naming a corporate trustee for such duties will provide an additional layer of protection for your family while still allowing you to designate one or more individuals to serve as the trustee(s) responsible for making all decisions concerning the business interests held by the trust.

If you are married, a Spousal Limited Access Trust (SLAT) is a special type of trust you may want to consider for transfers of business interests because your spouse can be included as a beneficiary along with your other family members without causing estate tax inclusion.

Trust distributions can be made to your spouse if needed to help maintain your accustomed manner of living and if properly structured your spouse can even act as the trustee to oversee trust distributions and investments. Depending on your situation and with proper planning to avoid the trusts being considered reciprocal, you and your spouse could consider establishing SLATs for the benefit of each other.

The advantages of an IDGT

A way to supercharge your planning is to structure your trust as an intentionally defective grantor trust (IDGT). An IDGT is designed so that the contributions you make to it are completed gifts removing all future appreciation on the trust assets from your taxable estate. At the same time, the trust includes special provisions allowing for it to be disregarded (i.e., “defective”) for income tax purposes and treated as a ‘grantor trust’ whose income remains taxable to you. Transactions between you and the IDGT including your sale of appreciated business interests to the trust are treated as nontaxable events for income tax purposes so no capital gains are realized.

Why would you want to continue to be responsible for paying ongoing income taxes on the business interest you have transferred to the IDGT? Well, your payment of the income taxes for the trust essentially amounts to a tax-free gift to the trust beneficiaries allowing a greater amount of wealth to be transferred to the next generation and out of your taxable estate.

To provide flexibility in case your financial circumstances change, the IDGT can include provisions allowing the trust to reimburse you for the tax payments you make. The IDGT can also be structured so that the grantor trust status can be turned off with the trust becoming responsible for paying its own income taxes.

Another attractive feature of the IDGT is that it can be structured to allow you to reacquire trust assets tax-free by swapping other assets into the trust of equal value. So if the trust owns an interest in your business you could take that interest back by swapping into the trust an equivalent amount of cash. This flexibility can be important if you need to change your succession plan because of unforeseen circumstances such as a child who is a trust beneficiary no longer being interested in helping to run the business.

Selling business interests to an IDGT for an estate freeze

From a pure estate tax reduction standpoint, the easiest and most tax effective transfer method generally would be for you to simply make direct gifts of interests in your business to your desired beneficiaries either outright or ideally to an IDGT. But if you have concerns about ensuring your own financial security or giving away too much, you may be more comfortable selling the business interest to an IDGT in

return for an installment note. This estate freeze strategy transfers all of the future appreciation on the transferred business interest out of your estate while paying you back over the time the discounted value of such interest plus a modest interest component.

The installment sale to an IDGT strategy is designed for businesses that are structured as pass-thru entities for income tax purposes like S corporations and LLCs. Because you will still be treated as the owner of the transferred business interest for income tax purposes, the IDGT can use tax distributions to make note payments to you. Any shortfall will need to be paid with additional distributions from the business or, if the business is eventually sold, from the IDGT’s share of the sales proceeds. Consequently, a very important precondition of implementing this strategy is that a financial analysis be done first to confirm that sufficient cash flow will be generated by the business to support the IDGT’s debt service obligations.

Here’s a look at how the transaction would work:

- **You would first make a gift to the IDGT equal to at least 10% of the value of the business interest being sold.** This is referred to as a “seed gift” which is used to support that the transaction is a bona fide business deal and that the IDGT is a creditworthy borrower with other available resources.
- **The IDGT will give you an installment note** equal to the fair market value of the business interest being sold (taking into consideration applicable discounts).
- **You can set the payment terms of the note** to amortize or be interest only with a balloon payment. Interest is typically set at the IRS Applicable Federal Rate and will not be taxable to you.
- **The IDGT will use distributions from the business to make payments to you on the installment note.** If the business cannot make sufficient cash distributions to pay amounts due on the note, the IDGT can make distributions in kind to you of its ownership interests in the business for debt service purposes. Any distributions in kind, however, will require a current valuation of the ownership interests transferred back to you taking into account applicable valuation discounts.
- **Your sale of the business interest to the IDGT will not be a taxable event** and no capital gains tax will be due. The transaction will be treated as a sale and not a gift because the IDGT has purchased the interest for fair market value.

After the note is paid off or if distributions from the business to the IDGT exceed what is needed for servicing the debt, such excess cash flow can be invested or perhaps used to acquire life insurance on your life to provide your family with tax free proceeds for additional liquidity upon your death.



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Sale of business interest to an IDGT



- John sells a 25% nonvoting interest in his business having an undiscounted value of \$10,000,000 to an IDGT for \$7,000,000 after application of a 30% discount.
- The IDGT is funded by John with a seed capital gift of \$700,000 which is applied against his lifetime gift tax exemption amount.
- The IDGT gives John a 9 year Note providing for annual principal and interest payments of \$800,500 with the interest rate set at 0.58% (the AFR for May, 2020)—for total payments back to John's estate after 9 years of approximately \$7,200,000. The Note could also be structured as interest only with a balloon payment and/or have a longer or shorter term.
- No capital gain is generated on the sale and interest on the Note is not taxable to John.
- Assuming the trust assets grow at 7% annually on the undiscounted value of the transferred business interest, at the end of 9 years approximately \$11,500,000 will have been transferred to John's beneficiaries with only the \$700,000 seed funding treated as a taxable gift.
- The end result is that taking advantage of the 30% valuation discount along with an anticipated growth rate on the transferred business interest well in excess of the .058% interest rate on the note allows for a substantial amount of value being transferred out of John's taxable estate at a very low gift tax cost. The estate tax benefit will continue to accrue going forward after the note is paid off as all future appreciation on the business interest held by the IDGT will also be removed from John's taxable estate.

Have a coordinated plan

The strategic planning for your business and your estate planning should go hand-in-hand. Our Business Owner Strategists can help you develop an integrated game plan that considers your family dynamics, ownership goals and leadership succession objectives in aligning the strategy for your business with your estate plan.

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