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BUSINESS SUCCESSION: TAX PLANNING *BEFORE* THE SALE

by Marvin E. Blum, J.D./C.P.A.
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When it comes to planning for the sale of a business, the end goal is simple: **maximize sales price and minimize taxes**. Achieving this goal can be complex, but it is important to remember that *timing is everything*. While maximizing sales price results from carefully preparing the business for sale, minimizing taxes results from creating a structure that increases the amount of the proceeds you actually get to keep. The rule of thumb is the more time you allow for planning prior to a sale, the greater the tax savings.

Even if you do not plan to sell the business to an outside party *or at all*, estate tax planning is a smart move for two main reasons: (i) it "squeezes" down the value by locking in discounts (for lack of control and lack of marketability) that may not be available in the future; and (ii) it "freezes" the value of the estate by moving future appreciation outside of your estate. This is known as "squeeze & freeze" planning.

Why Estate Freeze Planning is Important

- When you die, if your assets are above the federal estate tax exemption level ($5,430,000 if single; $10,860,000 if married), the federal government will take 40% of those assets.
- Many people currently under the exemption level are growing their estates, and their net worth will well exceed the exemption level by the time they die.
- Their family will have only nine months to find the liquidity to pay the estate tax.

Estate Planning Also Provides Asset Protection

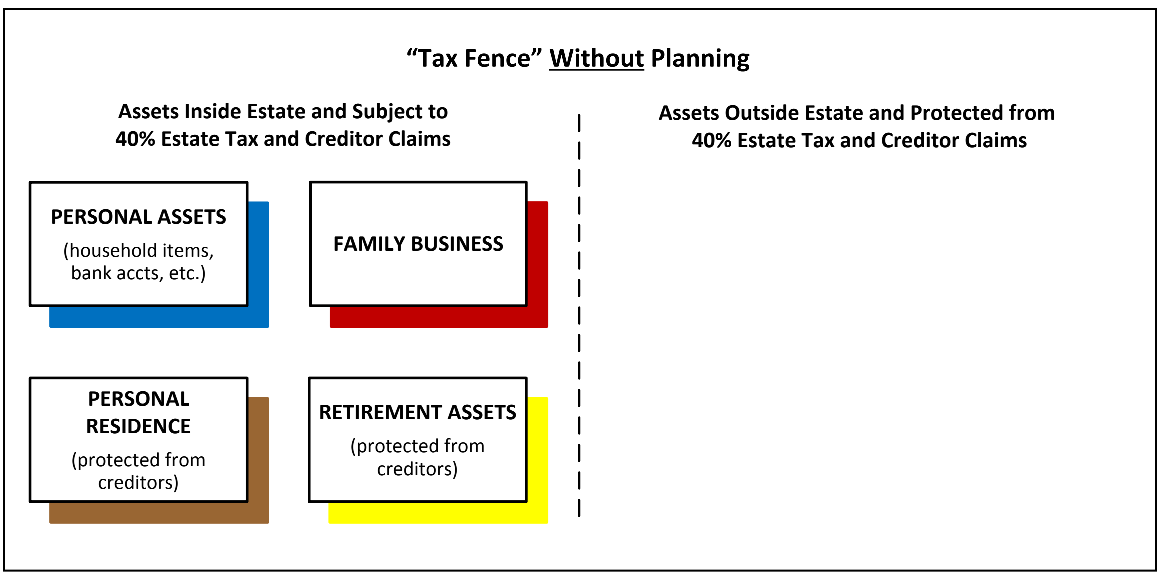
- If you are sued and have a judgment against you, the creditor can take assets you own in your own name.
- Transferring assets out of your name prevents creditors from having access.
- By and large, except for retirement assets, **you should never own any assets in your own name**.
- Assets should be put into entities like limited partnerships, and the entities should be owned by trusts.

An Example of the Consequences of Doing No Planning

- Bob and Lisa together had a very large estate. Although they had a high net worth on paper (family business valued at $75 million and $10 million in other assets), their estate was very illiquid.
- When they both died unexpectedly in an accident, the IRS sent their children a tax bill for $30 million ($85 million less $10 million in exemptions, x 40%).
- An IRC Section 6166 long-term payout was not a satisfactory solution for the family.
- The children had to resort to a fire sale of the business to pay the tax.

Many people are reluctant to engage in estate freeze planning because of the fear that they will lose access to and control of an asset after it is removed from their estate. This is especially true when the asset is a family business. But, **there is a way to have your cake and eat it too!**

Through 678 Trust planning, business owners can move the business outside of the estate (thereby "freezing" the asset's value for estate tax purposes), **without giving up control and without giving up access to the asset**. Let's rewind the clock on Bob and Lisa and show what would have happened with proper planning. . .



First Layer of Tax Planning: Examine the Entity Structure

- Create a structure that qualifies for the best possible valuation discount.
  - If an LLC or Limited Partnership, examine the agreement to ensure that the entity will qualify for an optimum valuation discount.
  - If a C Corporation, transfer stock to a limited partnership.

  - If an S Corporation, reorganize the structure to establish 1% voting and 99% non-voting shares. Perform tax planning with the non-voting shares, which qualify for a valuation discount.

<u>Second Layer of Tax Planning: A Grantor Trust for the Children</u>

- Bob and Lisa create an Intentionally Defective Grantor Trust for their children (the "Children's Trust").
- Assets held in the Children's Trust are outside of Bob's and Lisa's estates for estate tax purposes.
- The Children's Trust can be structured so that the assets also avoid estate tax at the deaths of Bob's and Lisa's children and possibly their grandchildren.
- Gifts made to the Children's Trust are "supercharged" because the grantors (Bob and Lisa) remain liable for the income tax attributable to the trust and pay the trust's income taxes, which helps to reduce their taxable estate.
- The payment of income taxes is not treated as a gift to the trust.
- The grantor status can be "toggled off" later if Bob and Lisa no longer wish to bear the trust's income tax.
- Bob and Lisa make a "seed gift" of 1/6th of the business to the trust, using a portion of each spouse's $5,430,000 lifetime gift tax exemption and generation-skipping transfer tax exemption.
- As beneficiaries, Bob's and Lisa's children and their descendants would be entitled to distributions as necessary for their health, education, maintenance, and support.
- The assets in the Children's Trust would be protected from the children's creditors and divorcing spouses.
- Bob's and Lisa's seed gift, assuming the family business is worth $75,000,000 and qualifies for a 35% valuation discount, has a value of $8,125,000, resulting in a gift of $4,062,500 from each of Bob and Lisa.
- As a result of the gifting, the 1/6th interest and any further appreciation on it are removed from Bob's and Lisa's estates.

<u>Third Layer of Tax Planning: 678 Trust "Estate Freeze"</u>

- Bob and Lisa still own 5/6th of the business. To transfer the 5/6th outside their estates, they sell it to a new 678 Trust (the "Family Trust") in exchange for promissory notes.
- A 678 Trust is a unique vehicle that combines asset protection, estate tax savings associated with the "estate freeze" techniques *and the continued ability to benefit* from the assets built up over the years.
- A 678 Trust is established by a third party (a parent, sibling, or close friend) with a gift of $5,000.
- Bob and Lisa SELL assets to the Family Trust; they never make a gift to it.

- Because the Family Trust is created by a third-party trustor, Bob and Lisa can be beneficiaries of the trust. They can also have a special power of appointment to direct where assets pass at their deaths.
- Because Bob and Lisa are the primary beneficiaries, they can receive distributions for health, education, maintenance, and support.
- For income tax purposes, Bob and Lisa will be treated as the "owners" of the Family Trust, which means there is no income tax when Bob and Lisa sell the business to the Family Trust. Also, Bob and Lisa will be responsible for paying the income tax on the income generated by the trust's assets during their lifetimes.
- Bob and Lisa should file Form 709 Gift Tax Returns to disclose the sale in order to start the running of the 3-year statute of limitations within which the IRS can challenge the valuation of the assets sold to the Family Trust. Without the statute of limitations running, the IRS could challenge the valuation and assess gift tax at any point in the future. The Gift Tax Returns will be due on April 15th of the year following the year in which the transaction takes place.
- Assets inside the taxable estate can be used to pay the income taxes, allowing the trust assets to grow without being depleted by income taxes.
- If Bob and Lisa were unable to pay the income taxes out of their own assets, the Family Trust could make payments on the notes owing to them.
- After the notes have been paid, the Family Trust could make a distribution to them in the amount of the income taxes due.

<u>Recap</u>

- Bob and Lisa made a "seed gift" of 1/6th of the business to the Children's Trust.
- Bob and Lisa sold their remaining 5/6th of the business to the Family Trust for $40,625,000 ($75,000,000 less 35% discount x 5/6 = $40,625,000).
- Bob and Lisa each received a 9-year promissory note for $20.3 million in return, plus interest at the mid-term applicable federal interest rate (currently, 1.6%).
- The Children's Trust pledged its assets to guarantee a portion of the promissory notes.
- The sale to the Family Trust immediately moved $21,875,000 out of their estates (the value of the discount) providing instant estate tax savings of $8,750,000.
- In addition, there was a $4,375,000 discount on the gift of 1/6th of the business to the Children's Trust, saving an additional $1,750,000 of estate tax.
- Total savings of $10,500,000 from valuation discounts alone.

<u>Results after Planning</u>

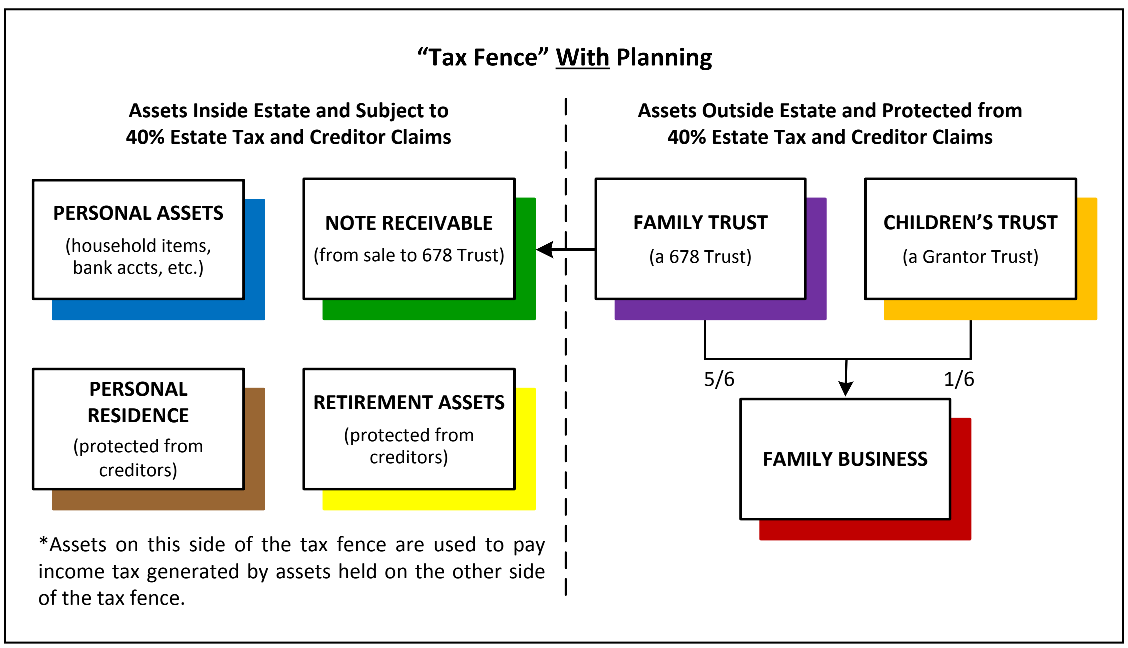
The Children's Trust:

- Owns 1/6th of the family business and will benefit from the future appreciation of the business.
- The assets within the trust are protected from creditors.

- The trust itself does not have to pay income tax as long as the grantor status of the trust is maintained.
- Will be protected from estate tax at the deaths of Bob and Lisa, their children, and possibly their grandchildren.

The Family Trust:

- Owns 5/6th of the family business and will benefit from the future appreciation of the business.
- The trust will make principal and interest payments on the promissory notes payable to Bob and Lisa.
- The assets in the trust are available for Bob's and Lisa's health, education, maintenance, and support.
- The assets in the trust are protected from creditors.
- Will be protected from estate tax at the deaths of Bob and Lisa, their children, and possibly their grandchildren.



Conclusion

- Assuming Bob and Lisa live until the promissory notes are paid in full and assuming assets in their estates have been spent down to cover living expenses and income taxes, their estate tax can be reduced to zero.
- Had Bob and Lisa not engaged in active estate planning, approximately $30 million in estate tax would have been due at their deaths.

- Additionally, there would have been a 40% estate tax on any appreciation if the business's value continued to grow.
- Upon the sale of the family business:
    - 1/6th of the sales proceeds pass to the Children's Trust.
    - 5/6th of the sales proceeds pass to the Family Trust.
    - ALL of the sales proceeds are outside of Bob's and Lisa's estates.
- This "squeeze & freeze" planning is just one way to eliminate the federal estate tax. There are other ways too. For example, the Sam Walton family used CLATs ("Jackie O Trusts") and GRATs to eliminate the tax. Choose a strategy that best fits the family.
- Because of these planning opportunities to eliminate estate tax, the estate tax is often referred to as a **"voluntary tax."**