THE WEALTH COUNSELOR

MONTHLY NEWSLETTER

Transferring Business Interests to Family Members: Sale of Non-Voting Stock Interests to Grantor Dynasty Trusts

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The Law Offices of Daniel B. Capobianco specializes in all areas of domestic and international taxation with emphasis on complex integrated estate plans with multiple tax strategies, charitable tax planning and business succession planning.

Estate planning involving the succession of a family business can be challenging because of the complex tax issues and the human element (egos, relationships, etc.) involved. This newsletter will examine a case study of how selling non-voting stock in a closely held business to a specific type of "grantor" dynasty trust can enhance an estate plan.

Assumed Facts:
Harry the husband, age 62, is married to Wilma the wife, age 58. This is a second marriage for both of them. They have no prenuptial agreement and no estate plan. Steve, who is Harry's son, is actively involved in Harry's business. Wilma's daughter Dottie is unemployed and not involved in Harry's business, which Wilma and Dottie resent. Harry and Wilma have one joint child, Mark, who is a minor and is also not involved in Harry's business. Neither Harry nor Wilma has used any of their $1,000,000 lifetime gift tax exemption.

Harry owns 100% of a business that is an S-corporation. It is very successful and has a current fair market value of $10 million. It also has significant cash flow and high growth potential. Harry's desire (which Steve shares) is for Steve to own and continue the business after Harry retires or dies.

There are significant other assets in the estate, including their home and other investments. Some are owned jointly by Harry and Wilma, and some are owned solely by Harry.

Under the probate laws of the state in which they live, if Harry dies intestate Wilma will receive half interest in each of Harry's assets and Steve and Mark will each receive a one quarter interest in each of them. As a result, Wilma, as Mark's guardian, will end up controlling 75% of the business while Steve will only control 25%. In addition, assuming Harry does not die in 2010, there will be a potentially huge estate tax liability. This is not what Harry wants to happen.

Harry's Goals and Objectives:

- To have a comprehensive plan that will ensure ownership of the business will pass to his son Steve. (Steve also wants the security of knowing the business will one day become his.)

- To be in control of the timing of the transfer of the business.

- To treat his stepdaughter and his younger son fairly.
- To have enough cash flow for now and to provide for Wilma if he dies first.
- To save estate taxes.

Steve does not have the cash to buy the business from him.

Phase 1: Reorganize and Recapitalize the S-Corporation
In a tax-free reorganization, convert the S-corporation to a limited liability company taxed as an S-corporation with voting and non-voting common units (or convert current common stock to voting and non-voting common stock).

Harry owns all of the 1,000 outstanding shares of the company. They are all voting shares. After the reorganization and issue of voting and non-voting membership units, Harry still owns 100% of the business, only now it is 10 LLC membership units (1%) that are voting and 990 (99%) that are non-voting. Why reorganization of the S-corporation into an LLC is part of the plan will be explained later.

Phase 2: Create Dynasty Trusts
Establish an irrevocable trust for each child that is designed so that its income is taxable to Harry and make initial contributions to the trust.

Harry creates three irrevocable grantor trusts, one for each child, in a jurisdiction that permits perpetual private trusts. The trusts are all "grantor" trusts for income tax purposes, but not for estate and gift tax purposes. Estate planners refer to these trusts using a variety of acronyms, like Irrevocable Deemed Owned Trusts (IDOTs), or Intentionally Defective Grantor Trusts (IDGTs).

As part of the plan, the grantor trust may contain a provision that will allow the income being taxed to Harry to be stopped if that becomes desirable later ("turning off" the grantor trust feature).

Harry makes a $600,000 cash gift to the trust established for Steve. This is a taxable gift that must be reported on a Federal gift tax return (IRS Form 709). However, no gift tax will be due because $600,000 of Harry's $1 million lifetime gift tax exclusion will be used to shelter the gift from taxation.

Harry will also allocate $600,000 of his generation skipping transfer tax exclusion to Steve's trust. Steve's trust will therefore have a zero inclusion ratio (i.e., have a 0% tax rate) for generation skipping transfer tax purposes.

Caution: In 2010, because the generation skipping transfer tax is suspended, this allocation cannot be made. Therefore, consider making late GST exemption allocations in 2011 when the GST returns, if Congress amends the tax code to permit doing so. Alternatively, delay implementing Phase 2 until 2011.

When Harry and Wilma make gifts to the trusts for Dottie and Mark, they do the same kind of allocations.

This trust structure provides a huge benefit to their descendants because the trusts' assets will never be included in their descendants' estates for estate tax purposes.

Phase 3: Sell Non-Voting Membership Units to Steve's Trust for an Installment Note
To give Steve ultimate ownership of Harry's business, start by selling all of the non-voting membership units to the dynasty trust for Steve.

To make a private sale or gift between family members of something valuable that does not have a known value, the IRS requires that a qualified valuation expert determine its fair market value. When what is sold or given away is an interest in a business, there are two steps to the valuation. First, the balance sheet assets owned by the business (real estate, specialized equipment, inventory, etc.) are valued. Then a business evaluation is performed to determine whether and to what extent the value of the assets underlying an interest in the business needs to be adjusted for lack of control over the business and lack of marketability of the membership interests.

The reason that the S-corporation was reorganized into an LLC taxed as an S-corporation is that limitations on the transferability of a business interest are disregarded in the valuation if they are greater than the default provisions of the state law that govern the business. The default provision for corporations is that there is no limitation on transferability. On the other hand, some states' default provision on LLC membership transfer is that all members must consent.

When the adjustments for lack of control and lack of liquidity are made to non-voting interests in an LLC, it is not uncommon that their cumulative effect is to depress the fair market value by a significant amount. In this case, we assume that the non-voting units' value will be depressed 40% because of lack of control and lack of marketability. Thus, the non-voting units will have a value of $6,000 per unit, making the total value of the 990 non-voting units $5,940,000.

Voting units will have a premium value to reflect the control value. In this example, the voting units have an appraised value of $12,000 per unit, making the total value of the 10 voting units equal to $120,000.

The fair market value of the entire company, sold as a unit, is still $10 million, but the value of the parts does not add up to $10 million! That it is only $5,940,000 + $120,000 = $6,060,000.

In this phase, Harry sells his 990 non-voting units to the dynasty trust for Steve using a 20-year installment note, payable annually. The note is for $5,940,000 (the fair market value of the 990 non-voting units) and is at a rate of 4.26% (which is slightly above the current long-term AFR rate). Based on the value and terms of the note, the trust will pay Harry $447,197 every year for 20 years. This is a legitimate arms-length business transaction because Steve's dynasty trust is a creditworthy borrower since its assets ($600,000 initial gift + $5,940,000 in LLC units) exceed the value of what it has bought by more than 10%.

Note: There is no "bright line" test for what is a commercially reasonable loan-to-value ratio. Many practitioners use 10%, but some are more comfortable at 20%.

Make sure the installment note is handled just like an installment sale to a non-family member or to a bank. Have a signed pledge or security agreement, pay any tax required, do any filings required. Make sure you have a documented paper trail.

The Outcome

Company Ownership and Control

After Phase 3 is completed, Harry owns 10 voting units, which gives him 100% control of the business and 1% of the equity. The dynasty trust for Steve owns 990 non-voting units, which gives it no control over the business and 99% of the equity. The dynasty trust also has $600,000 in cash that Harry gifted to it.

Income Tax Reporting

Harry is deemed to be the "owner" of the dynasty trust for Steve for purposes of reporting its income. As long as that is so, the dynasty trust for Steve does not have to file a Form 1041 fiduciary income tax return. Instead, an information return is filed, with the dynasty trust income tax information reported to Harry as the trust's deemed owner, for reporting on his personal Form 1040 income tax return.

Income Tax Effect of Sale of Membership Units
Harry's sale of LLC units to the dynasty trust for Steve is a "non-recognition" event. Because Harry is the deemed owner of the trust for income tax purposes, it is treated as a sale by Harry to himself. Thus no gain is recognized on the sale of the stock and no interest income is recognized on the installment note payments. Of course, the trust does not receive a deduction for interest payments made either.

"Pass Through" Dynasty Trust Income
Income from the LLC will be allocated to the unit holders based on their unit ownership percentages. Let's assume the business has $500,000 in net income. Harry owns 10 voting units, which is equal to 1% of the equity. Therefore, Harry will be allocated $5,000 in K-1 income. The dynasty trust for Steve owns 990 non-voting units, which is equal to 99% of the equity. Therefore it will be allocated $495,000 in K-1 income.

Because the dynasty trusts are structured as grantor trusts for income tax purposes, Harry must pay the income tax attributable to all of their income, including the S-corporation income that is allocated to the trust for Steve. But that is what he was doing before the sale of his non-voting units to Steve's trust, so he is paying the same income tax before and after the sale of the units. Harry's payment of the trusts' income tax is not an additional gift to the trusts, which means that every year Harry is transferring, gift tax free, additional estate assets to the trusts for the children.

How the Dynasty Trust Makes the Required Note Payments
We assume for this case study that the LLC will have $500,000 per year of cash flow to distribute to its unit holders. That will provide Steve's dynasty a cash distribution of $495,000 ($500,000 x 99% = $495,000). Thus at the end of year one it will have $1,095,000 in cash ($495,000 from the LLC and the $600,000 that was gifted to it as seed capital). The trustee can thus easily make the $447,197 note payment to Harry.

If the company does not generate enough income to pay the note, take the same approach as if a borrower can't repay a bank loan. Options would include deferring payment until such time as the business recovers or renegotiating the term or interest rate of the note.

Results After Year One
At the end of the first year, the note has been reduced to $5,745,847 and the dynasty trust has a cash balance of $647,803. The trustee of the dynasty trust could use this cash to:

- Invest and save. (Income taxes on the earnings would be taxed to Harry.)
- Make distributions to the trust beneficiaries. (Distributions would be gift tax-free.)
- Buy life insurance on Harry's life.

Harry has received $5,000 from the LLC and $447,197 from the note payment, for a total of $452,917 in income. He will pay income taxes on this full amount. For example, if he is in a 25% effective income tax bracket (after all deductions), he would pay $125,000 in income taxes, leaving with him $327,917 income to support his and Wilma's lifestyle and/or make annual exclusion gifts to the dynasty trusts for Mark and Dottie, which they could use to buy life insurance on Harry's life. (This would be an excellent way to provide for Mark and Dottie.)

There may be other sources of income. For example, Harry is still in control of his company, and he may receive a salary as well as compensation as a Director on its Board. Alternatively, Harry may be able to reduce his salary from the LLC if he does not need the cash flow. This would save payroll tax and would give the business more cash flow.

When Harry Dies

If Harry has either consumed or gifted the net after the tax note payments that he receives from Steve's dynasty trust, only the unpaid balance of the note will be included in his taxable estate; there is no asset "build-up" inside his estate as the company grows.

The dynasty trust for Steve is GST "exempt" so that following Harry's death its assets will never be subject to estate, gift or GST taxation.

So are the dynasty trusts established for Dottie and Mark, so the life insurance proceeds received by them on Harry's death are also GST "exempt," providing a legacy for them and their descendants.

Harry could leave the 10 voting units (1%) to Steve in trust, too.

This arrangement would leave Steve's trusts owning 100% of the business and the other children's GST exempt trust shares owning cash.

Harry's wife Wilma will continue to receive the remaining note payments for her support.

Estate Tax Results

- Harry has “frozen” the value of his business at $6,060,000 and completely removed all appreciation attributable to that asset from his gross estate that, at his death, would be subject to estate tax. Unless the Congress acts quickly, the top rate after the catch-up tax will be 55% in 2011.

- Harry has received an asset (the self-amortizing note) that is based on a discounted asset value, frozen (will not appreciate in value) and depreciating (the note principal will decrease over the 20-year note amortization term).

- If Harry does not accumulate the note payments, then at the end of the note term (20 years), he will have totally removed the $10,600,000 (plus all future appreciation on this amount) from his gross estate without making a taxable gift other than the initial $600,000 seed capital gift.

- The trust assets are in a generation skipping tax-exempt trusts that can include asset protection features. These trust assets are not included in the children's or grandchildren's gross estates at their deaths.

Conclusion

Using this technique, all of Harry's goals and objectives were met. His son Steve would receive the business without having to buy him out, yet Harry could control the timing of the business transfer. He was able to provide for his other children and his wife. In addition, Harry saved substantial estate taxes.

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