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Three Great Succession Strategies for your Business[i]

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California business and property owners often hold strong values and wish to keep their assets in the family or preserve their business as a legacy. If the business or land is worth more than a few million dollars, tax liabilities may make this goal impossible without some advance planning. Here are three strategies business owners should be aware of.

1st Strategy: Thinking Outside the Box on Annual Gifting

Consider the case of a father and vineyard owner in Saratoga, California. The father's largest asset was his Saratoga land and vineyard, worth approximately $6 million. He was worried that upon his death, his two daughters would be forced to sell the vineyard in order to pay the estate tax. He sought the advice of an estate planner, who created a plan to save taxes in order to keep the vineyard in the family. Over the next 20 years, the father made gifts of shares of the vineyard equal to the annual gift tax exclusion amount (for 2009, this would be up to $13,000 per year, per daughter). Upon his death, he had already gifted 53% of the value of the vineyard to his daughters. This resulted in what is called a "minority share discount valuation," where a minority interest in a business, if sold, would go for less than a full interest. In the father's case, an appraiser "discounted" the vineyard by 20%. By implementing this plan, **the two daughters saved a substantial amount in estate taxes and were not forced to sell the vineyard**.

2nd Strategy: Using GRATs to Transfer Ownership Tax-Free

What if a business owner didn't have 20 years to give, or quite simply didn't have the patience to give over 20 years? The father in the above example could have considered a number of advanced planning strategies that, with a bit of luck and foresight, could achieve even better tax savings.

Let's consider the case of a very successful yoghurt business owner in Palo Alto, also the proud mother of two daughters. Assume that a decline in property and asset values has decreased the yoghurt shop's value from $6 million to $5 million (this may seem all too real). The business owner is confident that the business' value will eventually rebound to $6 million or higher, and ultimately wishes to pass on the business to the two daughters. The shop owner transfers a discounted interest in the corporation or family limited partnership (FLP) holding the yoghurt shop to a Grantor Retained Annuity Trust (GRAT). The GRAT specifies an annuity to be paid back yearly over 5 years and names the two daughters as beneficiaries. Let's assume that after a discount in valuation, the interest is worth $2.5 million.

By way of background, a GRAT is a type of trust that pays an annuity to the grantor based on a fair market value calculation of the property at the time of creation; the GRAT applies an interest rate published monthly by the IRS called the 7520 rate. Once annuity payments are paid out, any remainder in the trust passes to beneficiaries, potentially without

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any gift tax. **If the annuity payment is set correctly, the GRAT is "zeroed out," such that all amounts pass to beneficiaries free of gift tax**. A GRAT works particularly well during economically depressed times when asset values and interest rates are low. During such times, it is more likely that GRAT assets will greatly exceed the sum of annuity payments, resulting in large tax-free gifts to beneficiaries. In January 2009, the 7520 rate was historically low-- 2.4%-- while property and stock valuations have collapsed. Moreover, since interests in a business can be discounted when transferred to a GRAT, this results in an even lower annuity payment. The result: an unprecedented time to transfer business interests tax-free in a properly structured GRAT.

Back to our example: Let's assume that the value of the yoghurt shop interest increases by 6% each year over five years (a very conservative increase). Under our formula, the GRAT makes annual annuity payments of $536,573 per year over 5 years by receiving dividends on shares or taking out a note against GRAT assets. After subtracting annuity payments and interest, the remainder passes to the daughters tax free. Thus, in our example, the shop owner transfers $320,853 in shares or membership units of the yoghurt business to her daughters, free of gift tax, over 5 years. Assuming that the shares or units continue to appreciate, **the shop owner has potentially transferred several million dollars worth of her business tax-free**. Keep in mind that we only assume a 6% increase per year in the Yoghurt shop shares. The actual increase in value may actually be greater, resulting in an even larger non-taxable gift. The business owner should be aware, however, that there is no step up in basis when transferring assets under a GRAT (as opposed to death-time transfers), that a death during the GRAT term would bring the shares or units back into her estate, and that the result would not be the same if the assets did not increase or actually declined in value. At the same time, in our example the business owner would pay no income tax on the annuity payments received.

3rd Strategy: The Self-Interested Conservationist

A third strategy involves the owner of a large amount of property, which may have been used for agricultural purposes or was simply part of a large estate. When the bulk of an estate is in land, an owner may be fearful that the land will be split up and developed after their death. This problem can be addressed by placing conservation easements on some or all of the land. Conservation easements can radically trim the estate tax bill while ensuring that land passed on to heirs or sold off will be used for agricultural or natural purposes.

To encourage families to conserve agricultural land, Congress passed legislation that allows taxpayers to make charitable deductions equal to the value of the conservation easement transferred to a qualified land trust or charity. In addition, landowners are permitted to take a deduction of up to $500,000 for 40% of the value of the land subjected to the easement.

Take the example of the vineyard owner, mentioned previously. Let's assume that the vineyard owner takes out a conservation easement on his land, perhaps because his desire is that his land be preserved forever as a vineyard and that his daughters will not be liable for an enormous tax bill at the time of his death. **Because the land on which the vineyard stands is now subject to an easement, it is valued lower for estate tax or gift tax purposes, making it easier for the daughters to keep the property**. For instance, assuming a maximum deduction of $500,000 and a decrease in value to $3 million after and the easement is imposed;

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a vineyard initially worth $6 million would only be valued at $2.5 million for purposes of the estate tax, after subtracting the $3 million charitable deduction. Of course, the heirs would have to restrict their use of the land to agricultural purposes. Therefore, conservation easements should only be considered if the family has no plans to develop the land and wishes to conserve it in its agricultural state.

Conclusion

For the business or property owner, there's more than meets the eye to planning a succession or keeping assets in the family. The key to success is thinking ahead. There's rarely a substitute for advance planning, and usually the benefits greatly outweigh the cost.

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[i] This article is intended to provide general information about estate planning strategies and should not be relied upon as a substitute for legal advice from a qualified attorney. Treasury regulations require a disclaimer that to the extent this article concerns tax matters, it is not intended to be used and cannot be used by a taxpayer for the purpose of avoiding penalties that may be imposed by law.