

 **PRESERVING WEALTH**

Wealth transfer and strategic alternatives

Holistic planning is key for family business owners, particularly in today's low-interest-rate environment.

By Donald P. DiCarlo Jr. and Matthew T. Panarese

LIKE MOST OWNERS of closely held family businesses, you're likely working hard every day to persevere through one of the worst economic downturns in our nation's history. The last thing you are focused on is how you will preserve your wealth and your business for future generations. However, now is the time to ensure that you have a solid plan in place that will not only help your successors take over your company, but also help to reduce the estate tax burden on the next generation.

Today's low-interest-rate environment may be putting a damper on some returns, but it has also created wealth transfer opportunities that make this an excellent time to shift assets to your heirs. As a business owner, you can implement a number of wealth transfer strategies and strategic alternatives to help you maximize your legacy's ultimate value.

Keep in mind that the current low interest rates will not last forever. In light of the mounting federal deficit, inflation is likely to increase. The increasing deficit also means that income tax and, possibly, estate tax rates may well rise for higher-income people. This increases the strategic value of removing assets from your estate before they incur higher taxes. Moreover, Congress is considering placing limits on the effectiveness of the

common wealth transfer strategies discussed below, especially grantor retained annuity trusts (GRATs). The Obama administration appears receptive to increasing taxes on the wealthy. If you act now to implement a long-term, multigenerational plan, tax benefits will be realized across the generations.

Wealth transfer strategies that take advantage of low interest rates

Reducing potential estate and gift taxes should be a critical component of your holistic plan. Consider the federal estate tax alone. Assets in your estate in excess of \$3.5 million (or \$7 million for a married couple who plan properly) will be taxed at 45%, with payment in cash due within nine months of your passing. With effective planning, your heirs can save 45 cents for every dollar removed from your taxable estate; that's like getting a 45% return.

There are many types of estate planning tools available that can help you transfer your wealth efficiently, particularly when interest rates are low. The following four strategies are most relevant to business owners interested in transferring wealth. They are particularly advantageous for transferring those assets that have the greatest potential for appreciation when the economy recovers.

- **Grantor Retained Annuity Trusts (GRATs).** A GRAT is a popular method of transferring the growth on assets held in trust to future generations at a greatly reduced gift tax cost. When you establish a GRAT to transfer all or partial ownership of your business, you make a gift of company stock (or other business interest) to the trust, pay a tax on valuation that the IRS places



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on the estimated value of the remainder interest of the trust when the trust is established, and retain an annuity stream for life, or for a fixed term. At the end of the period, the remaining assets pass to family members outright or in further trust. A gift tax deduction is allowed for the actuarial value of the interest retained, so the amount of the taxable gift may be quite small. If the asset growth outperforms the statutory rate used to calculate the retained value, the additional growth is transferred free of gift and estate tax to the trust's beneficiaries. The GRAT continues to be a popular planning technique because there is very little downside. The owner is not required to give up interest in the business assets and, even if the business value does not appreciate as expected, the owner is no worse off than he or she would have been without a GRAT.

- **Charitable Lead Annuity Trusts (CLATs).** A CLAT works like a GRAT, except that the annuity goes to a charity instead of to you. With a CLAT, the trust provides an annual payment to one or more charitable beneficiaries for a certain amount of time, with the remainder interest going to family members or a family trust. Because you, as the grantor, will receive a gift tax deduction for the value of the charities' interest, CLATs are a way to "leverage" gifts to family members. They can also be structured in different ways to take advantage of income tax deductions.

- **Installment sale to irrevocable grantor trusts.** Rather than gifting your business to your heirs, it sometimes makes sense to sell it to them (or to a trust for their benefit), especially when you can charge a very low interest rate and still have the sale respected for tax purposes. Selling shares of your company to an irrevocable grantor trust combines several benefits. You can sell an asset to your heirs via what is called a "grantor trust" and charge a very low interest rate without making an outright gift, thus avoiding gift tax; you can sell assets to the trust and not incur any capital gains on the appreciation; and because the trust allows you to pay all income taxes on it, you can essentially increase your gift to your children by relieving them of the need to pay.

- **Simple gifts and loans.** Outright gifts and loans to your children or other heirs are always an option, with gifting being the most straightforward. Low values in real estate and the stock market can make this an excellent time to gift such assets to your children directly and/or to fund irrevocable trusts. For direct gifts made in 2009, the annual gift-tax exclusion is \$13,000 per recipient, and the lifetime gift tax exemption is \$1 million per individual donor. Unlike when inheriting an asset, however, the person receiving the gift will not get a "stepped-up" basis for capital gains tax purposes, so you want to choose assets carefully.

In today's environment, loans are also more attractive than usual because you can make loans at lower interest rates. Your heirs will benefit if whatever they use their loans for delivers a return in excess of the low interest rate currently allowed by the IRS. An intrafamily loan may be an effective way to help a child purchase a home or car, or perhaps even allow your child to participate in your next business venture. Alternatively, the child may invest the proceeds in the market, and any amounts above the allowed loan rate earned on the investments will not be subject to gift tax. Either technique could succeed in removing future appreciation from your taxable estate and thereby reduce tax costs.

Strategic alternatives: Trade-off between value and control

If you care about creating the greatest value for your company, you should consider strategic alternatives in addition to your more tax-oriented wealth transfer planning options.

Many business owners balk at considering the sale of all or part of their enterprise for a number of reasons. But it is possible to implement the following strategies without sacrificing control. The trade-off is that when

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you retain more control, you'll typically raise less cash.

- **Debt dividend recapitalization.** This option is most attractive for owners who want to take a dividend funded by debt. Of the four strategic alternatives discussed in this section, it leaves the business owner with the greatest control over the firm. This strategy may be used more than once, offering flexibility and the chance to benefit as the company grows.

- **Minority equity recapitalization.** Like debt dividend recapitalization, minority equity recapitalization is for owners who want to raise cash without giving up complete control. It yields more cash than debt dividend recapitalization because some ownership is transferred. The private equity firm that acquires an interest in the business will also gain input into your company's direction. Of the three equity strategies discussed here, this strategy gives up the least amount of control, and for that reason it also yields the lowest valuation of the three strategies.

- **Majority/100% sale to a private equity firm (financial buyer).** A majority or 100% sale to a private

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equity firm will yield greater value than the two alternatives discussed above. Your firm may also benefit from having a partner who can provide capital for growth. Often a seller can structure the transaction to include participation in future performance of the company; however, control of your company will be lost.

- **Sale of 100% interest to strategic buyer.** You can typically gain the highest valuation when you sell 100% of your company to a strategic buyer. That's because a strategic buyer can benefit from synergies with other parts of the buyer's company, unlike a private equity buyer, and can therefore pay more. On the downside, you not only lose control of your company but also have no opportunity to participate in its future growth.

Planning is essential

Lack of proper planning that incorporates all aspects

of your business—and personal—finances and circumstances is a surefire way to lose the family business you've worked so hard to create. Every family and business is unique, with its own set of family dynamics and goals for the future, so it's critical to work with your wealth, tax and legal advisers to create the plan that's best for you. Once you put a plan in place, revisit it and update it as needed. As your family and business change, so should your plans for their futures.

With 2009 coming to an end, it seems unlikely that there will be major estate tax law reform this year. It is likely, however, that the 2009 estate tax laws will be extended into 2010. Many experts think that with such an extension, Congress could allow the \$3.5 million estate tax exemption to revert back to \$1 million in 2011. This should provide even more reason for you to consider planning now. FB

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