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Tax Free Transfers of a Family Business

(The Greatest Thing Since Sliced Bread?)

By James G. Clements

The transfer of a family business from one generation to the next raises many difficult business and estate planning questions. What will be the effect of a change of ownership (legal control) and management? Which children will participate in management and in what positions? If children who do not work in the business have an ownership interest then how will children who do work in the business reap their fair share of its success? On the other hand, if children who are not involved in the business receive no ownership interest then how will they otherwise receive their fair share of family wealth? Planning for the transfer must be done with great care in order to preserve family harmony as well as the viability of the business.

The non-tax issues tend to be better resolved when a business is transferred during the lives of the parents who remain available to provide continuing guidance. Moreover, there are significant tax advantages. A lifetime transfer will result in a so-called "estate freeze", i.e., all future income of the business as well as all future appreciation in its value will be removed from the parents' taxable estates.

A lifetime transfer will necessarily involve either a gift or a sale. The primary challenge, therefore, is how to avoid paying gift tax on a gift or capital gains tax on a sale. For Federal gift tax purposes, only $1 million can pass tax-free by reason of the Unified Credit. Annual Exclusion gifts are limited to $11,000 ($22,000 for married couples) per donee. Although there are methods available for reducing the gift tax burden, the gift option is often not as attractive as the sale option for businesses of more substantial value.

How then can a family business be sold without paying income tax on the gain? Fortunately, the Internal Revenue Service (IRS) has, to its chagrin, shown us exactly how to do it!

Many years ago when the top income tax rate for individuals was 91%, the IRS adopted so-called "grantor trust" rules to prevent high bracket taxpayers from shifting income, through the use of certain types of trusts, to their children who were in much lower brackets. Basically, if a taxpayer (the "grantor") transfers property in trust for a child but retains certain powers over the trust, the IRS will tax all trust income to the higher bracket grantor rather than to the trust or the children. A typical power would be the power to reacquire property by substituting property of equivalent value. The law now clearly dictates, *for income tax purposes only*, that a trust containing such powers (a "defective" trust) must be totally ignored as an entity separate from the grantor. Accordingly, a sale of a family business to what has become known as an "Intentionally Defective Grantor Trust" (IDGT) will be treated as a sale by the taxpayer to *himself* and, as such, will not be subject to capital gains tax. This rule, coupled with other tax law changes, including those which now tax individuals more favorably than trusts, has completely turned the tables on the IRS and provided significant income, gift and estate tax savings opportunities.

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Perhaps the benefits can best be illustrated by an example. The structure of the transaction will depend on the type of entity involved but let's assume the business is an S corporation. This means that corporate profits, whether or not distributed, are taxed directly to the shareholders (not to the corporation). Let's further assume that the business, as a whole, is worth $6 million and is owned by one parent who has a tax cost basis of $1 million in the stock. A separate IDGT is created for each of three children and one-third of the stock is sold to each IDGT in exchange for interest bearing promissory notes due in 12 years, using as collateral the stock sold to the trusts. "Balloon" notes are used, which means that principal is not due until the end of the term but may, at any time, be prepaid in part or in whole. Annual principal payments will be made by the trusts from periodic distributions from the company. Since each IDGT gets only 1/3rd of the stock, a total discount in value of about 35% should be allowable because each sale is of only a minority interest and the stock is not publicly traded. The discount will reduce the total sales price to $3.9 million. If properly structured, the tax ramifications should be as follows:

Capital Gains Tax: No tax on the capital gain of $2.9 million ($3.9 million sales price minus $1 million tax cost basis).

Income Tax: Since the trusts are disregarded for income tax purposes, interest paid on the notes is not taxable income to the parent.

Profits distributed from the business to the trusts do not result in any additional tax in the case of an S corporation. Although such profits are received by the trusts and used to pay the notes, the profits are nevertheless taxed, under the "grantor trust" rules, to the parent who in turn uses the annual note payments to cover his or her tax liabilities. Since the parent is merely satisfying tax obligations imposed by the "grantor trust" rules, the payment of tax on profits used to pay the parent for the stock constitutes, in effect, tax free gifts to the children's trusts. Again, thank you IRS!

Estate Tax: The business is not included for estate tax purposes because the sale to the trusts is a completed transfer for estate tax purposes.

As a result of the discounted sales price, the parent instantly reduced his or her estate by $2.1 million by substituting $3.9 million of promissory notes for stock worth $6 million. The value of the unpaid principal, if any, remaining on the notes is included in the parent's estate. Any unused Unified Credit remaining at the parent's death may shelter some or all of the notes from estate tax.

Gift Tax: None, provided the value of the business transferred does not exceed the value of the promissory notes received. It is therefore imperative to obtain a professional appraisal to substantiate the sales price. ■

Helpful Tip: *In order for a sale of a business to an IDGT to be respected as a bona fide transaction, the IRS suggests the trust have other assets equal to 10-15% of the sales price for repayment of the notes. This can often be accomplished through gifts exempt from tax under the Unified Credit.*

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