



Sharing the wealth

Estate planning with business ownership interests

You've worked hard to build a successful business. Now it's so valuable that there's likely to be a tremendous strain on your family's liquid resources when it comes time to pay estate taxes at your death. To lessen the estate tax burden, consider reducing the value of your estate by divesting yourself of some of your business interests during your lifetime.

Annual exclusion gifts

One way to start divesting yourself of your business interests is to gift them to loved ones. With proper planning, you can save significant taxes and retain control of your company.

The first step is to use your \$12,000 per beneficiary annual gift tax exclusions. For example, Jim, a widower, owns a business worth \$4 million. He has five children and nine grandchildren. Using his annual gift tax exclusions, Jim can transfer \$168,000 worth of shares of stock in his S corporation annually without incurring any gift tax.

Minority interest discounts

Minority, noncontrolling interests in a business generally are considered to be worth less than majority, controlling interests. To reflect this difference, appraisers typically apply a valuation discount when valuing minority interests. Such discounts allow you to leverage your gifts to transfer more value.

For instance, in the previous example, Jim is retaining more than 50% of the company, so he's giving away minority interests. Assuming a 30% discount, Jim can increase the underlying value of his gifts to \$240,000 of stock each year but be treated as having made only \$168,000 in annual exclusion gifts. This translates to removing 6% of the \$4 million value of his company from his taxable estate in one year.

Your lifetime gift tax exemption

You can further increase the size of your gifts by tapping your \$1 million lifetime gift tax exemption — assuming you haven't already used it. In the previous example, factoring in the 30% valuation discount, Jim can gift nearly \$1.43 million, or an additional 35% of his company shares, to his children and grandchildren gift-tax-free with his lifetime exemption. All told, he can divest himself of nearly 47% of the company in just two days — if he makes annual exclusion gifts on Dec. 31 of one year and Jan. 1 of the next.

An added benefit is that future appreciation on the gifted business interests won't be included in your estate. For example, as the value of Jim's company increases, almost half of the increase will inure immediately to his children and grandchildren. Of course, Jim's plan can backfire if the company's value decreases.

It's also important to note that any lifetime gift tax exemption you use will reduce the estate tax exemption available at your death. But the benefit of removing future appreciation from your estate likely will outweigh the loss of some of your estate tax exemption.

Selling your business interests

Giftng is perhaps the easiest way to transfer your business interests to your family during your life, but another option is to sell the interests to them.

A direct sale probably would be inadvisable because you'd owe income tax on the gain. But by using an intentionally defective grantor trust (IDGT), you can structure a transaction that allows you to transfer business interests to your children at today's value without having to recognize gain on the sale.

This specially designed trust works because it is excluded from your estate for estate tax purposes but is treated as yours for income tax purposes. And, you'll use significantly less of your lifetime exemption than you would have used had you gifted the interests outright.

In fact, if you've already created an IDGT that holds assets, you can complete the transaction without using any additional gift tax exemption amount. By virtue of the fact that you no longer own the business interests, any appreciation attributable to them will go to the trust and, ultimately, your children as beneficiaries of the trust without being included in your estate.

As an added bonus, an IDGT provides an opportunity to make additional gifts without using any more of your annual exclusions or lifetime exemption. When the trust is properly structured, you, as grantor, are responsible for paying the tax on the trust income.

That income, though, remains in the trust. Thus, the trust assets are not reduced by the tax. The IDGT value, therefore, increases and, because you're paying tax on the IDGT's income, your taxable estate will decrease.

Of course, you may get to the point where you're no longer interested in paying the tax on the trust income. In that case, you have two options: The trustee can reimburse you for income taxes paid on trust assets, or you can "cure" the defective nature of the trust, and the trust will thereafter be responsible for the tax on any income it earns.

Treading carefully

Even though the strategies discussed here focused on transferring S corporation shares, these principles apply to most other business entities as well. One important caveat to keep in mind is that shareholder agreements or other documents may be in place that can restrict your ability to transfer business interests.

Making the decision to give away interests in the company you built up over your lifetime can be difficult, but it also can be one of the best things you do for your family. Knowing there are many ways to accomplish your objectives, be sure to choose the one or ones that will best fit your needs.

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