

Top three estate planning ideas for business owners*

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Every business owner needs to plan ahead to protect the family wealth through proper estate planning as part of an overall business plan.

With talk of Congress leaning toward a compromise on repealing the estate tax law by freezing the amount of the estate tax exemption amount at \$3.5 million, repeal seems unlikely. Now is the time to reevaluate your estate plan.

What to count on when estate tax repeal is uncertain

If you have been watching for signs that the federal estate and gift tax system might settle down since Congress instituted changes in 2001 with the Economic Growth and Tax Relief Reconciliation Act, the next few years could be filled with transitions, and a good time for business owners to keep their estate plans in order.

“It’s best not to assume that the estate tax, which included gradual reductions in transfer tax rates and increasing exemptions—such as on gift tax and generation-skipping transfer (GST) tax—through 2010, will be repealed in the near term,” observes Evelyn Capassakis, PricewaterhouseCoopers’ Private Company Services principal. “Though planning in a changing tax climate can be a challenge, it is essential for business owners—as part of their overall business plans—to protect their family wealth through proper estate planning.”

Though there has been uncertainty over whether or not the estate tax law would be repealed in 2011, when the tax law is scheduled to return to its 2001 state, it sounds as if Congress is leaning toward a compromise to repeal. A possibility that is gaining traction is to freeze the amount of the estate tax exemption at \$3.5 million, which it is scheduled to reach in 2009. Keep in mind that there is no proposed change to the gift tax exemption, and to the extent that exemption is used during life, it reduces the amount of the estate tax exemption remaining and available at death. [See chart below.]

Guide to the current tax law and exemptions through 2011 Year-by-year transfer tax rates and exemptions

Year	Estate tax exemption	GST tax exemption	Gift tax exemption	Highest estate, GST, and gift tax rates
2008	\$2 million	\$2 million	\$1 million	45%
2009	\$3.5 million	\$3.5 million	\$1 million	45%
2010	n/a (taxes repealed)	n/a (taxes repealed)	\$1 million	35% (gift tax), 0% (estate and GST tax)
2011 and later	\$1 million	\$1 million	\$1 million	55%

Proper estate planning should be an important part of every business owner's overall business plan. Business owners seeking to make the most of their legacy need to engage in basic estate planning activities that enable them to accomplish their goals most effectively.

"Most taxpayers can accomplish significant estate planning objectives simply by taking advantage of lifetime gift-giving," says Capassakis. "This includes making maximum use of the annual exclusion, making lifetime use of the gift tax exemption, and making lifetime taxable gifts."

Three top lifetime gift-giving techniques for business owners

Three top estate planning techniques that business owners can employ in the current environment are 1) making annual exclusion gifts, 2) passing along appreciation in assets through Grantor Retained Annuity Trusts (GRATs), and 3) providing descendants access to assets through a trust.

Making annual exclusion gifts

One of the most frequently overlooked or misused techniques is the annual exclusion gift. If you've got a large family, you can transfer significant amounts of wealth simply by making annual exclusion gifts. Every taxpayer can transfer up to \$12,000 per year to as many donees as they wish, free of estate, gift and GST taxes. Annual exclusion gifts can be made to minors by using a Uniform Transfers to Minors Act account under applicable state law, or through a minor's trust that meets the requirements of the Internal Revenue Code.

Top three estate planning mistakes

Successful business owners tend to be shrewd planners, but when it comes to estate planning, there are areas in which it doesn't pay to push the limits. Following are three top estate planning mistakes:

- 1 Cutting corners and skipping the formal valuation when making a gift of a business. "If the valuation used for gift tax purposes is found to be incorrect, then the gift would use part of and reduce the gift tax exemption or could be taxable if it exceeds that amount," says Capassakis. "However, given the change in the gift tax statute of limitations there may now be greater certainty with respect to valuations."
- 2 Trying to retain voting or other control after giving away trustee powers either by imposing some kind of family partnership or keeping strings on a trust. This control may bring the transferred business value right back into the estate.
- 3 Running personal finances through the business, such as borrowing money, after giving away ownership. Again, this causes the IRS to argue that the business should be included in the estate of the owner, on the theory that the business was never really given away.

For example, suppose you have three married children and five grandchildren. Giving \$12,000 to each of these 11 donees totals \$132,000. By getting this amount out of your eventual estate, you would save \$59,400 in estate taxes if you are in the 45% estate tax bracket. If you make annual exclusion gifts in each of two calendar years, you can transfer \$264,000, for a \$118,800 tax savings. “You are also transferring out of the estate the growth in value of the asset after the date of transfer,” notes Capassakis. Depending on how young you are, the growth on the assets can be quite significant.

If your spouse is also a US citizen or resident, you can double the gifts. If you and your spouse elect on a timely-filed gift tax return, you can treat the gifts as made one-half by each of you, thereby doubling the benefit. In the example above, you would be able to transfer \$528,000 over two years. “It’s important to note that you and your spouse must consent to split all the gifts made to third parties by either of you during the year, not just annual exclusion gifts.” For example, in a year where you elect to split gifts you can’t make a significant gift to heirs that uses up some of your lifetime exclusion without also using up some of your spouse’s. You can’t pick and choose which gifts you split and which you don’t.

Passing Asset Appreciation through Grantor Retained Annuity Trusts

A favorite technique for transferring appreciation in assets to heirs continues to be the Grantor Retained Annuity Trust, or GRAT. A GRAT is a trust to which the grantor transfers assets and retains the right to a specified annuity from the trust for a set term. At the end of the term, assuming the grantor has survived, the assets pass to or in trust for the grantor’s specified heirs and are not included in the grantor’s estate. If the grantor does not survive the term, part or all of the trust assets may be included in the grantor’s gross estate.

The GRAT is particularly attractive for grantors with an interest in a closely held company that may be sold, either via a public or private sale. If the grantor transfers a minority interest in the company to a GRAT prior to the sale, it might be possible to value the company taking into account a minority interest and lack of marketability discount. Once the company is sold, usually at going concern value, with a commensurate premium, rather than a discount, the often-significant appreciation could pass directly to the beneficiaries instead of becoming part of the business owner’s estate.

“It is important that the transfer does not take place too close in time to the sale or initial public offering so that the IRS does not argue that the appreciation has already taken place, and value the gift at the sales price,” notes Capassakis. How close in time is “too close” depends on the facts, but if there is a written sales agreement, it is probably too late.

Providing access to assets through a trust

Another way to keep gift tax and estate tax from eating up significant value of the business that you wish to pass along to descendants, but not actually giving it to them outright, is to give them access to assets in an ordinary trust. Often a business owner’s greatest asset is the business itself, and the owner might not have assets with which to make annual exclusion gifts. If this is the case, you can put stock in an ordinary trust and give beneficiaries withdrawal powers, known as *Crummey* powers after a 1968 case on this matter known as *Crummey v. Commissioner*. As with the GRAT, transferring a minority

interest in the company to an ordinary trust prior to selling your business might make it possible to value the company at the time of the gift by taking into account a minority interest and lack of marketability discount.

Doing this, and combining the gift with your annual exclusion gifts, makes the strategy very powerful.

If you use the annual exclusion to make gifts of property other than cash, such as an interest in your business, minority interest and lack of marketability discounts could be available that allow you to transfer a greater interest in the business using the same annual exclusions, than you would be able to transfer if you were not able to avail yourself of discounts. Say you have a 30% combined discount for lack of marketability and minority interest. Then, over four years you and your spouse would be able to transfer \$1,500,000 in value of a business. Assuming a 30% discount, the value is reduced to \$1,050,000. Then, this interest could be transferred using \$525,000 of the same \$528,000 of cumulative annual exclusions over two years, as described above. Over 10 years, you could transfer over \$3,750,000 in business interests, using just the annual exclusions. This is a much more powerful result than giving the beneficiaries \$12,000 in cash each—even assuming the cash was available, and you were so inclined.

In addition to the annual exclusion amount, to the extent the gift tax exemption is used during life by giving away stock of the business, any future appreciation on that stock also escapes estate and gift taxation.

Planning as part of business strategy

As a business owner, when determining who will benefit from your assets and how, you must take into account practical considerations such as:

- Are you concerned about who will run the business after you retire or are deceased?
- Is it important that the business remain in the family? If so, will you arrange to transfer control of the business over your lifetime to save on estate taxes?
- Will you need the business to provide cash flow for your retirement without sacrificing family control?
- Will there be provisions made to protect long-term employees or customers?

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