SMALL BUSINESS SOLUTIONS

Window of Opportunity for Business Succession Planning

>>>Significant advantages exist until 2013 for business owners considering relinquishing control of their companies.

By Jerome A. Deener

The 2010 Federal Tax Act created a short window of opportunity for business owners to plan for business succession from senior to junior family members. The 2010 Tax Act increased federal gift and estate tax exemptions to $5 million ($10 million for a married couple), but only until December 31, 2012. Exemptions after that date are reduced to $1 million ($2 million for a married couple). While Congress can modify the scheduled reduction before 2013, there is currently no consensus, creating uncertainty after 2012. The next 18 months thus provide an unusual opportunity to transfer $5 million to $10 million of business value without incurring the gift tax.

Assumed facts: A father, 60 years old, owns a successful business valued at $10 million in which his son, age 35, is employed. The father will retire in a few years and wants to transfer ownership to his son. Assume the business doubles in five years to $20 million, resulting in combined federal and state estate taxes of $7.2 million.

At least three planning opportunities exist before December 2012 to reduce or avoid the tax:

1. **Outright gift of non-voting interests to leverage the exemption:** The business may be recapitalized so the father receives 1 percent voting control and 99 percent non-voting interests; the father, with the mother's consent, could gift 99 percent non-voting interests to the son, retaining control of 1 percent voting interest for a desired period of time; because son is receiving non-voting interests, gift tax value of such interests could be eligible for discounts of (say) 40 percent. The gift of 99 percent non-voting interests would then be valued at just under $6 million (within the $10 million exemption available to married couples) so no gift tax is due; if the business does double in value to $20 million, the son will own 99 percent of the enhanced value. The father could give or sell his 1 percent voting interest to his son at a future date without tax. More than $14 million can potentially escape federal and state tax consequences.

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2. **Sale to son.** The father can sell 99 percent non-voting interest to a trust for his son for $6 million using the same discount methodology as in a gift. The trust could issue a promissory note for the selling price, with interest at the current favorable IRS interest rate, and amortizable to accommodate the business' cash flow.

If the sale is structured as grantor trust, the father will pay no income tax on proceeds, but will continue to be taxed on income from the 99 percent business interest owned by the trust, generating tax-free gift to the son of the income taxes. The father could later gift or sell 1 percent voting interest to his son.

3. **Gift to a Grantor Retained Annuity Trust (GRAT).** The father could transfer 99 percent non-voting interest to a GRAT, which would provide that the father retains a specified annuity from the trust for a certain period of time. The GRAT enables the father to retain cash flow for a period and avoid gift tax consequences. Thus, the father is deemed to pass current and future growth without using any exemption. To be successful, the father must survive the stated period of the trust. NJB

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