Transferring Control: Minimize Federal Taxes

~ Rose-Anne B. Frano & Elizabeth P. Diaz

Generation by generation, family businesses have become a cornerstone of the American economy. These businesses are estimated to be responsible for a majority of the United States Gross National Product and employ a majority of the US workforce. However, many owners now are looking to retire or otherwise transition out of positions of leadership and ownership. The statistics regarding survival of such owners' businesses after transition are not encouraging. In part, the narrow survival rates may be because only a small fraction of family business owners have invested the time necessary to properly craft a formal business succession plan, including preparing for the payment of federal estate taxes that result from including the value of the family business in their estates upon death. Here we will summarize a few estate planning techniques and tax planning considerations that owners of family businesses may consider to help minimize the federal gift and estate tax consequences of transferring their ownership of business entities to the next generations. Please note this article is not intended to be an exhaustive review of generational family business succession. To be effective, any business succession plan requires the current ownership and leadership to invest significant time and analysis to thoroughly construct a plan that will successfully transfer a family business to a new generation of ownership and leadership. However, we hope this article helps outline a few of the common starting points.

As general background, the United States transfer tax system levies taxes on transferring property from one person to another during one's lifetime (the federal gift tax) and at death (the federal estate tax). For various reasons, it is often beneficial for people to transfer assets during their lifetime rather than at their death. One reason is that certain lifetime gifts may qualify for the federal annual gift exclusion (currently $14,000 in 2016). Another reason is that many gift techniques "freeze" the value of the asset at the time of a gift, which shifts future appreciation of the gifted property out of the donor's estate. A final benefit of gifting is that the federal gift tax is "tax-exclusive," meaning that the gift tax due is based on the value of the property received by the recipient of the gift, with the amount paid in federal gift tax not being subject to additional federal gift taxes. The federal estate tax, on the other hand, is "tax-inclusive," meaning that the estate tax due is based on the value of a decedent's entire gross estate, including any assets that may ultimately pass to the federal government through payment of estate taxes. Because lifetime gifts are tax-exclusive, lifetime gifts can provide an opportunity to generate overall transfer tax savings to a family in the generational transfer of its family business interests. While there are many techniques available to reduce transfer taxes related to lifetime transfers, here are three frequently considered structures.

GRAT

A Grantor Retained Annuity Trust (GRAT) is a trust for a term of years (at least two years under current law). The grantor transfers assets, such as family business interests, to the GRAT and retains an interest in the trust for that term of years. This retained interest is an income interest stated as an annuity percentage of the original assets transferred. The present value calculation for the annuity percentage is made using a combination of the grantor's life expectancy and the interest rate (the 7520 rate) in effect when the GRAT is created. Each year, the GRAT will pay the grantor the required annuity from the trust assets, and at the end of the GRAT term, any remaining assets and all appreciation over that interest rate inure to the benefit of the GRAT beneficiaries. GRATs can be structured with different terms that cause different federal gift tax outcomes. Such variations include the ability to transfer future appreciation of family business interests to the next generation with virtually no federal gift tax or with the planned payment of some federal gift tax. Such flexibility in planning exists because, under the current federal gift tax laws, the gift will be calculated using the subtraction method, in which the present value of the annuity payments to the grantor is subtracted from the original value of the assets placed into the GRAT. Because the GRAT is a grantor trust, the grantor, instead of the trust itself, will be responsible for the payment of all the federal income tax due from the activity within the trust during the GRAT term. Since the IRS has ruled that payment by the grantor of the GRAT's federal income tax is not a gift, the grantor can increase the value of assets passing to the next generation by paying the GRAT federal income taxes. In general, the GRAT is most successful when the transferred asset values are expected to appreciate, when the applicable interest rates are low, and when the transferred assets' federal income tax bases are equal to fair market value (because the transferred assets retain the grantor's federal income tax basis).

Though the GRAT is an excellent planning tool, it carries a mortality risk and certain legislative risks. For the GRAT to avoid estate tax inclusion, you, the grantor, must outlive the trust's term. GRATs are often discussed by lawmakers and the IRS as trusts they would like to regulate more closely and restrict (e.g., requiring a minimum term of years for the GRAT to exist). Additionally, because the annuity payment to the grantor is calculated as a percentage of the value of the GRAT assets, when a family business is contributed to a GRAT, it is necessary to obtain a qualified appraisal of the contributed business interests. Also, if the net income of the GRAT is not sufficient to satisfy the required annuity payment to the grantor, the trustee of the GRAT must distribute principal assets to the grantor to satisfy the annuity payment. In such a scenario, if the GRAT only holds the family business interest, then the trustee will be required to obtain another qualified business appraisal to determine the principal interests necessary to satisfy the annuity distribution. Obviously, obtaining one or more business appraisals can be costly and cause significant administrative burdens to the GRAT trustee.

As a final consideration, it is important that the grantor of the GRAT discuss with his or her attorney and tax preparer whether a Federal Gift (and Generation-Skipping Transfer) Tax Return ("Form 709") must be filed or may be in the grantor's best interests to be filed. The Form 709 must be filed on or before the due date of the grantor's federal income tax return, including extensions, for such year that the GRAT is funded. The Form 709 must be prepared carefully to include all required information regarding the GRAT funding, including the qualified business appraisal. Additionally, the appropriateness of filing a Form 709, even if not required, is an important discussion to have with your attorney to ensure you are considering applicable statutes of limitations and other aspects of disclosing the GRAT transaction on the Form 709.

IDGT

An Intentionally Defective (yes, we mean "intentionally defective") Grantor Trust (IDGT) is a trust designed to take advantage of the differences between who is treated as the owner of property for federal income tax purposes and who is treated as the owner for federal gift and estate tax purposes. This estate planning technique typically involves the grantor forming an IDGT and then selling the grantor's assets, such as business interests, to the IDGT for a promissory note of some length, with an interest rate at least equal to the applicable federal rate (AFR). The IDGT is drafted to deliberately violate a provision of the grantor trust rules found in the Internal Revenue Code so that the grantor continues to be treated as owning the business interests for federal income tax purposes (and not trigger any capital gains tax because of the sale to the IDGT), even though the business interests have been sold to the trust for federal gift and estate tax purposes. A carefully structured and maintained IDGT should remove the business interests from the grantor's estate while permitting federal income tax-free transactions between the grantor and the IDGT during the grantor's lifetime. In practical terms, this means the grantor could accomplish the sale of the family business for federal gift and estate tax purposes without being treated as selling the family business for federal income tax purposes. However, since the transaction is a sale to a trust created by the grantor, you should consider certain commercially reasonable standards. For instance, the IDGT should be able to pay the grantor a reasonable down payment with the issuance of a promissory note, or perhaps a security agreement should be in place to ensure the note. If you are considering creating an IDGT, understand that the structure and details involved in the sale of your family business to an IDGT must be carefully reviewed throughout the implementation and maintenance of the IDGT.

An IDGT is most advantageous when the business interests (that are now held in the trust) will appreciate far more than the note interest rate (that is held by the grantor). The result is that the sale of the business interests "freezes" the business's value for federal gift and estate tax purposes at the sale price, allowing for all the appreciation (over the note interest payments due to the grantor) to pass to the IDGT's beneficiaries (i.e., the next generation) without federal gift tax consequences.

Though the IDGT is an excellent planning tool, if the IRS believes that you, the grantor, sold your business interests to the IDGT for less than fair market value, the IRS can treat the transaction as gifts to the IDGT or reject the IDGT altogether, treating the business interests and all their appreciation as though still a part of your estate. It is imperative to carefully structure and maintain the IDGT to successfully remove assets from your estate while still permitting federal income tax-free transactions between you and the IDGT during your lifetime. Additionally, like the GRAT, a qualified appraisal of the business entity must be obtained when the IDGT is created and funded, and you should discuss with your attorney and tax preparer whether such transfer should be disclosed on a Form 709, even if otherwise not required.

FLP

Although often used in the popular press and by practitioners, the term "family limited partnership" (FLP) has no particular legal significance and merely refers to a limited partnership or limited liability company, all the partners or members of which are members of the same family. FLPs have become popular tools for reducing federal estate and gift taxes; however, they have many other benefits and advantages that are maximized only when they are properly organized, managed, and maintained. This estate planning technique involves a transferor (typically a parent) transferring certain assets to the FLP. The parent can be the general partner or managing member of the FLP (owning at least a 1 percent interest in the entity and maintaining control of the business). The transferor can also own the limited partnership or minority membership interests in the FLP. After the FLP has been established and funded, the parent may consider gifts of ownership interests in the FLP to children or other family members. The parent also may consider whether to retain control of the business or transfer control as part of the FLP formation or operation process. One advantage of FLPs and of transferring part or all of control as part of an FLP business succession plan is that valuation discounts associated with the lack of control and marketability of owning a partial interest in a business (as opposed to the entire business) can allow the parent to shift business interests to the next generation at a lower federal estate and gift tax cost than a direct transfer of such assets during lifetime or at death. Ideally, the gift of an ownership interest in the FLP can be structured to utilize the parent's federal annual gift tax exclusion (currently $14,000 per beneficiary in 2016) and lifetime federal transfer tax exemption equivalents (currently $5.45 million in 2016). To the extent gifts are made, future appreciation in the value of the business representing those gifted interests can be removed from the parent's gross estate for estate tax purposes. At any time that interests in the FLP are gifted, it will be necessary to obtain a qualified appraisal of the business interests (and the underlying assets owned by the FLP) to reflect such transfers on a Form 709, if required or determined otherwise to be appropriate.

Though FLPs have many advantages, the IRS has demonstrated a pattern of vigorously challenging and opposing FLPs and the discounts afforded to them for federal estate tax purposes. The IRS has argued that FLPs should

be disregarded (meaning that no discount applies at all) or that much smaller discounts should apply (meaning additional tax, penalties, and interest may be due). Because of this heightened scrutiny, you should ensure the transaction is carefully structured, operated correctly and carefully, and that all members of the family fully understand the requirements of such an operative structure. FLPs are businesses and must be operated as such to fully maximize the structural, operational, and federal transfer tax benefits.

We cannot discuss the aforementioned techniques without acknowledging Chapter 14 of the Internal Revenue Code. In general, Chapter 14 limits the ability of a family member to transfer assets (and future appreciation related thereto) to other family members in any number of estate planning transactions without realizing certain calculated transfer tax obligations from such transaction. Estate planning transactions affected by Chapter 14 include (but are not limited to) GRATs and the transfer of family business interests to other family members when the transferor retains certain discretionary rights, options, or distribution and liquidation rights in such business. Accordingly, in utilizing any of these estate planning techniques, and in all business succession plans, you should work carefully with your attorney to ensure the transaction is structured to avoid or carefully comply with the requirements of Chapter 14 of the Internal Revenue Code.

Finally, most business succession plans do not transfer from the owner all interests in the family business. Thus, any interest in the family business owned by a decedent as of his or her date of death will be included in his or her gross estate for federal estate tax purposes. Resultantly, a common challenge for any estate in which a significant portion of the fair market value of a gross estate is composed of family business interests is a possible lack of liquidity in the estate to pay the federal estate tax, which is due nine months after the date of death. Accordingly, without proper counsel, the family may need to quickly sell the family business interest to create liquidity to pay federal estate tax. The Internal Revenue Code contains several provisions to aid family business owners in these situations. One such provision is Section 6166 of the Internal Revenue Code. In general, Section 6166 provides that if the gross estate of a decedent includes an interest in a closely held business conducting an active trade or business, and the value of such interest exceeds 35 percent of the value of the adjusted gross estate, the personal representative of the estate may elect to pay part or all of the estate tax that is attributable to such closely held business in no more than 10 equal installments. If the personal representative makes such election, which must be made by the due date of the Federal Estate (and Generation-Skipping Transfer) Tax Return ("Form 706"), the first installment may be deferred for up to five years after the date prescribed for the payment of tax, with each succeeding installment becoming due one year after the date the preceding installment is due. Additionally, during the estate tax deferral period, interest must be paid, and all deferred taxes may be accelerated if the conditions of Section 6166 no longer apply. Thus, if your estate plan is considering using Section 6166 for estate tax deferral, it is important during

the estate planning process to ensure the amount of the retained business interest, and your participation in such business, will qualify for such estate tax deferral. Then, during an estate administration in which Section 6166 applies, the personal representative must monitor the estate's adherence to the requirements during the entire deferral period.

Successfully navigating your family business through generations of owners and managers is hard. The planning related to successful transfers begins not when you are ready to transfer the business, but long before as you analyze and organize the path of transfer. One major consideration of such transfers of family businesses through generations is transfer tax planning (although we only discussed federal transfer tax, careful analysis should also include any related state transfer tax rules). The three vehicles discussed in this article are but a tip of the iceberg of considerations and planning. So, start early and involve your entire team of advisors—business advisors, business managers, attorney, and tax professionals. The path of planning business succession may be long and challenging, but the reward of comfortable and sustainable transfer is invaluable.

Rose-Anne is a Williams Parker shareholder.
She is a board certified specialist in wills, trusts, and estates. Rose-Anne focuses on estate, gift, and generation-skipping transfer tax planning for individuals and their families and on the administration of estates and trusts. She earned her LLM in Taxation and her JD from the University of Florida College of Law and her BA from Tulane University.

Liz is an associate with Williams Parker.
She practices in the areas of taxation, estate planning, and estate administration. Liz earned an LLM in Taxation from the University of Florida and earned her JD and her MBA from Stetson. In addition to her LLM and JD, Liz is a Florida-licensed CPA.