AKD Consultants
Adam Dworkin
CPA
188 Whiting Street
Suite 10
Hingham, MA 02043
781-556-5554
Adam@AKDConsultants.com

Other Transfer Strategies and Considerations

Other Transfer Strategies and Considerations

Other transfer options

In addition to selling your business outright or gifting your business to your heirs, there are other strategies and options that you can use to transfer your business to your heirs. These options include transferring your business into a grantor retained trust, selling your business through an installment sale, or recapitalizing the equity structure of the company and retaining an interest. You should consult your attorney to determine the benefits and drawbacks of each of these options, as these will differ depending on the circumstances of your particular business and your own personal circumstances.

What is a grantor retained trust?

A grantor retained trust is a type of irrevocable trust. An individual (called the grantor) transfers assets into a trust and then retains an interest for a period of time. The retained interest may be the right to receive annuity or unitrust payments or may be the right to use the property in the trust. At the end of the retained interest, the property in the trust will pass to the beneficiaries of the trust.

Grantor retained trusts are valuable estate planning tools because the value of the initial transfer into the trust can be discounted for federal gift tax purposes. The size of the discount will depend upon the length of the retained interest and the applicable federal interest rate that must be used to discount the gift. Furthermore, if the grantor outlives the term of the retained interest, then the assets, including any appreciation in the assets, is not included in his or her taxable estate. Thus, transferring assets into a grantor retained trust can be an excellent way to remove assets (especially appreciating assets) from your estate while allowing you to receive a benefit from those assets for a certain period of time.

What are the different types of grantor retained trusts?

There are three types of grantor retained trusts:

Grantor retained annuity trust

A grantor retained annuity trust (GRAT) is an irrevocable trust into which you transfer assets (such as cash, stocks, bonds, and real estate) and then retain an annuity interest for a set period of time. With a GRAT, the annuity payments you receive will be a fixed amount. The payments from the trust can be made to you either once a year or more often, if you desire. At the end of your retained interest (which can last for as long or short a period of time as you like), the assets in the trust will pass to the beneficiaries of the trust. The beneficiaries will typically be your children or grandchildren. The initial transfer of assets into the GRAT is considered a taxable gift. However, for federal gift tax purposes, you can discount the value of the gift. The size of the discount will depend upon the length of the retained interest and the applicable federal interest rate. The longer the retained interest, the more the gift can be discounted. You can also use your applicable exclusion amount (formerly known as the unified credit) to protect some or all of the gift from the federal gift tax. If you outlive the term of the retained interest, the assets in the GRAT, including any appreciation in the assets, will not be included in your taxable estate. If you do not outlive the term of the retained interest, part or all of the assets in the trust at the time of your death will be included in your taxable estate.

Grantor retained unitrust

A grantor retained unitrust (GRUT) is an irrevocable trust into which you transfer assets (such as cash, stocks, bonds, and real estate) and then retain a unitrust interest for a set period of time. With a GRUT, the unitrust payments you receive will be a fixed percentage of the value of the assets in the trust. The assets will then be revalued each year. Thus, if the value of the assets in the trust increases, the payments to you will increase as well. The payments from the trust may be made to you once a year or more often, if you desire. At the end of your retained interest (which can last for as long or short a period of time as you like), the assets in the trust will pass to the beneficiaries of the trust. The beneficiaries will typically be your children or grandchildren. The initial transfer of assets into the GRUT is considered a taxable gift. However, for federal gift tax purposes, you can discount the value of the gift. The size of the discount will depend upon the length of the retained interest and the applicable federal interest rate. The longer the retained interest, the more the gift can be discounted. You can use your unified credit to protect some or all of the gift from the federal gift tax. If you outlive the term of the retained interest, the assets in the GRUT, including any appreciation in the assets, will not be included in your taxable estate. If you do not outlive the term of the retained interest, part or all of the assets in the trust at the time of your death will be included in your taxable estate.

Grantor retained income trust

A grantor retained income trust (GRIT) is an irrevocable trust into which you transfer property and then retain the right to use or hold that property for a set period of time. A GRIT differs from a GRAT or GRUT because the creator of the GRIT does not usually retain a right to payments. Rather, the grantor of the trust retains the right to simply use or hold the property for a certain period of time. The property must be tangible property that would not be depreciable or depletable and as to which the nonexercise of your rights in the term interest would not affect the value of the remainder interest. The grantor may transfer a piece of artwork into the trust, for example, and then retain the right to hang that artwork in his or her home for a period of time. Like a GRAT and a GRUT, the transfer of the property into the trust is considered a taxable gift. However, the value of the gift can be discounted. Here, the value of the gift of the remainder is equal to the value of the property you transferred to the trust reduced by the amount for which your retained interest could be sold to an unrelated third party. Furthermore, if the grantor outlives the term of the retained interest, the assets in the GRIT will not be included in that person's taxable estate.

Installment sale

An installment sale is a transaction in which you sell your business to another individual and the payments are spread out over two or more years. To qualify for installment treatment, at least one payment must be made in a year after the year of the sale. Other than this one requirement, you have a great deal of flexibility in how the payments can be structured. They can begin and end whenever you (and the buyer) want them to. For example, you may want to receive the payments in years when you will be in a lower income tax bracket. Another advantage to an installment sale is that the taxable gain on the sale of a cash-basis taxpayer business can be spread over the term of the installment payments, and you do not have to pay the entire tax at the time of the sale. With the sale of an accrual method business, however, you are required to pay the full tax on the gain at the time of sale. There may also be estate tax savings--at the time of your death only the present value of the unpaid installment payments must be included in your taxable estate. Finally, unlike a private annuity, you may retain a security interest in the business during the term of the installment payments.

Retained interest

A retained interest involves a recapitalization of your business (in a tax-free reorganization) by dividing the common stock of the company into two classes of stock--voting and nonvoting stock. Once the two classes of stock have been created, you retain the voting stock and then gift away the nonvoting stock to your children and heirs. You can then maintain control of your company while gifting away some of the equity to your heirs. The gift to your heirs may qualify for the annual exclusion from the gift tax. You may also be able to discount the value of the gift because of the lack of marketability and the minority interest. By using the annual exclusion and the valuation discount, you can transfer a substantial amount of the nonvoting stock to your heirs without incurring a gift tax. The value of that stock, including any appreciation in that stock, will then not be included in your taxable estate.

After-sale considerations

Many of the transfer techniques discussed above involve a payout of the sale price of your business over a period of time. You may be concerned about protecting yourself in the event the buyer defaults on payments due to you or has financial troubles. You might even be concerned about a default if the buyer is a family member. However, there are several steps you can take to protect yourself when you sell or transfer your business to a new owner. Your lawyer can draft many of these protections right into the purchase and sale agreement. You can do the following: require the new buyer to maintain certain financial ratios (debt-to-equity, cash flow percentages, etc.); have the buyer personally guarantee the payments; have the new owner sign a noncompetition agreement; restrict additional financing; have a third party secure the financing; and retain some voting rights in the company.

Cash flow and balance sheet requirements

One way to give yourself some protection against the buyer defaulting on payments is to require the company to meet certain financial goals during the term of the payments. For example, you could require that the company meet certain debt-to-equity ratios. You could require that the company maintain a certain cash-flow ratio. If the company failed to meet any of these financial ratios, that would constitute a default by the buyer.

Guarantees, caps, and dividend limitations

Another way to protect yourself is to require the buyers to personally guarantee the payments to you. You may even want to have the buyers pledge personal assets to secure the payments. You could also put a cap on how much the new owners can pay themselves (either in salary or in bonus). Finally, if the company is an S corporation, you could require that the company limit the dividends that it pays on the S corporation stock.

Noncompetition agreements

Another technique to provide some protection is to require the new owner to sign a noncompetition agreement, restricting the ability of the new owner to set up a competing business should the business you sell to him or her fail. You don't want to be in the position of providing training for the new owner at your expense. You may also want to restrict the right of the new owner to sell off assets or even parts of the business.

Restrictions on additional financing

Another protection strategy is to restrict the new owner from taking on additional financing during the term of the payout to you. You don't want the company to be saddled with additional debt while payments are still being made to you.

Third-party security

You may also require the new owner to have a third party --a bank, for example--collateralize or secure the payments to you. The bank could issue a letter of credit, guaranteeing that the payments will be made to you if the buyer should default. However, a letter of credit and other third-party security arrangements can be quite expensive. A new owner may be very hesitant to incur this expense.

Retained voting rights

A final option is to retain some sort of voting rights in the company. For example, instead of selling or transferring 100 percent of your stock in the company, you might only sell 80 percent. Prior to the sale, you could amend the company's bylaws to require that any major action by the company require an 81 percent vote of the stockholders. You would then have a veto over any major actions that the company might take. In this way, you could protect your interest in the business.

IMPORTANT DISCLOSURES

Broadridge Investor Communication Solutions, Inc. does not provide investment, tax, or legal advice. The information presented here is not specific to any individual's personal circumstances.

To the extent that this material concerns tax matters, it is not intended or written to be used, and cannot be used, by a taxpayer for the purpose of avoiding penalties that may be imposed by law. Each taxpayer should seek independent advice from a tax professional based on his or her individual circumstances.

These materials are provided for general information and educational purposes based upon publicly available information from sources believed to be reliable—we cannot assure the accuracy or completeness of these materials. The information in these materials may change at any time and without notice.

AKD Consultants
Adam Dworkin
CPA
188 Whiting Street
Suite 10
Hingham, MA 02043
781-556-5554
Adam@AKDConsultants.com