TRANSFERRING WEALTH TO CHILDREN: A PRIMER FOR BUSINESS OWNERS

WHITE PAPER

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Introduction

Both business owners and non-business-owning parents want to transfer a monetary legacy to their children, if possible. However, business owners are different in the tools they can use to transfer wealth.

Whether you own a business or not, the fundamental questions are the same:

1. How much wealth do you want to keep?
2. How much wealth do you want the kids to have, and how much is too much?
3. Which tools minimize the estate- and gift-tax consequences of transferring wealth?

Business owners have to put those questions in the context of their Exit Objective: "How much money do I wish to have after I exit my business?"

Once owners establish their financial Exit Objective, they can answer the universal questions above and design a transfer mechanism that will pass their wealth to their children with minimal tax impact.

This white paper discusses the following three-part process:

1. Fix the owner's financial objectives *before* considering a wealth transfer.
2. Determine the amount of wealth to be transferred (and determine how much is too much).
3. Design a wealth transfer strategy that keeps the IRS from becoming the largest beneficiary of the owner's hard-earned cash.

To illustrate how one fictional business owner answered these questions, let's look at the case of Doug Joyce, a composite of a number of successful business owners.

Doug opened his meeting with his Estate Planning attorney with an announcement: "I think I've waited too long to begin gifting part of the company to my son, Barry, who runs the business with me. My CPA just told me that my company could be worth $12–15 million to a third party, because it consistently generates $2.5 million in cash flow annually. I had no idea it could be worth so much!

"Since I don't need that much, I want to transfer at least half the value of the business—at a lower valuation of course—before any possible sale. I know I can give small chunks of stock to Barry in amounts equal to my annual exclusion, and I'm willing to consider using part of my $5 million lifetime gift exemption."

"I want to keep most of my estate-tax exemption to provide the same level of benefit for my other two children. My wife thinks we should give those two the same amount I want to give Barry—just not using business interest as the gift."

"My CPA told me to meet with you because she thinks there are ways to increase the amount of my gift to Barry without paying gift taxes—especially when combined with gifts to my other two, non-business-active kids. If you've got any suggestions, I'm all ears."

Doug's attorney pointed out that using both his and his wife's annual gift-exclusion amounts and his $5 million lifetime gift exemption were sound ideas, but, used alone, they would not transfer even half of his total

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wealth (about $25 million) to his children. Even combining Doug's and his wife's full lifetime gift exemptions, the transfer to their kids would be well less than half of their total wealth.

Two issues were compounding the problem:

1. Doug had good reason to believe that the company's cash flow would continue to grow from its current $3 million by at least 25% per year for the next three years.
2. Doug faced uncertainty about whether the estate-tax exemption would remain at $5 million.

"Given how much more valuable my business will be in a few years, won't it be even more difficult to transfer wealth to my kids? How can I give my kids as much money as possible without paying any more in taxes than absolutely necessary?"

Doug's prediction of rapid future growth was music to his attorney's ears.

"Doug, the more rapidly your business grows in value, the more cash it spins off, the easier it is to give wealth away and give it away quickly—with little or no gift-tax consequences."

The attorney suggested that Doug and his wife answer the first two questions—how much wealth do you want to keep, and how much wealth do you want the kids to have—and that they all meet in a few weeks to explore answers to the third (which tools minimize the estate- and gift-tax consequences of transferring wealth?).

Question One: *How much wealth do you want when you leave your business?*

The primary decision every parent makes when transferring wealth to children is not how to accomplish the transfer (that's the Estate Planning attorney's job) but *how much* wealth to transfer to the children. To answer that question, business owners must revisit their financial Exit Objective, "How much wealth do you wish to have after you exit your business?" The amount of wealth that owners wish to leave their children usually (but not always) depends on how much the owners wish to keep after they exit their businesses.

As a general rule, we discourage parents from giving significant gifts to children until their own financial security is assured. Only after the parents' needs are met do we ask how much is enough—or too much—for the kids.

The first step in creating a comprehensive Exit Plan is for owners to determine their objectives. Without goals, there can be no plan and owners are rarely able to leave their businesses on their terms.

As a quick review, the three Exit Objectives that every owner must fix are best phrased as questions:

1. How much longer do I want to work in the business?
2. What is the annual after-tax income I want (in today's dollars) during retirement?
3. Whom do I want to transfer the business to?

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The answer to the second question not only establishes the owner's personal financial goals but also provides the takeoff point for how much money the owner can afford to leave to his or her children. Most owners draw upon the expertise of their financial and investment planners or Exit Planning Advisors to help answer that question.

Question Two: *How much wealth do you want the kids to have, and how much is too much?*

For many successful business owners, the question of how to leave as much money as possible to children forces the more important question: Given the financial success of the business, how much money *should* the children receive, and *how much is too much*?

Doug observed, *"I want to give the kids enough money to do anything, but not enough to do nothing."* That's a noble sentiment, but one that is difficult to execute without careful planning.

Doug preferred that his children receive nothing over creating entitled "trust babies."

When owners wrestle with the question of "too much," remember that children need not receive money outright. Rarely are large amounts of wealth transferred to children freely or outright. Instead, access to wealth is restricted through the use of family limited partnerships (or limited liability companies) and the use of trusts. These tools are primarily designed to reflect the parents' desire to restrict their children's (and their spouses') access to wealth. This is true regardless of the amount of wealth the parent wishes to transfer. Let's look at the steps in a typical "access/control" scenario.

Controlling Access to Wealth

Controlling your children's access to your wealth can be assured through the following three steps:

Step One. Parents form a limited liability company (LLC) or family limited partnership (FLP) in which the parents own both the operating interest (or general partnership interest) and the limited partnership interests. Limited partners have no ability to compel a distribution, compel a liquidation of the partnership (or LLC), or vote. In short, limited partners enjoy few rights and have no control.

Step Two. Trusts are created for the benefit of each child. The trusts will eventually own the limited partnership interests. A child will be entitled to receive distributions from the trust based on guidelines, parameters, and restrictions that the parents prescribe in each trust document.

Restrictions can take several forms. The most common restrictions limit a child's right to gain access to funds held in the trust. Typically, distributions are made over a series of ages (e.g., one-third of the trust principal at age 30, one-third at age 40, and the balance of the trust principal at age 50). The intent is that children be sufficiently mature to handle the assets. Further, if a child mishandles an early distribution, he or she can learn from his or her mistakes and presumably will not repeat them with later distributions.

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Parents can use generation-skipping trusts (or dynasty trusts) to allow a child access to trust funds but without compelling distributions. Although these trusts are controlled by state law, benefits of these trusts may include (a) the avoidance of estate taxes when the child dies and (b) creditor protection. Creditors (including ex-spouses) may have no ability to access trust assets (depending, of course, on trust design).

Some parents link distributions to children to the child's achievement of written standards contained in the trust. These standards can include the following:

- **Earned income**. For example, if a child earns $60,000 annually in her employment, she would be entitled to receive an equal amount or some other percentage from the trust.
- **Legal activities**. A parent may wish to distribute money to children who engage in (what the parent believes to be) socially useful activities (e.g., teacher in a public school, an artist, a writer, an Exit Planning Advisor).
- **Illegal activities**. Parents may forbid children from receiving any distributions they would otherwise be entitled to if convicted of a crime or addicted to an illegal substance.
- **Existence of a premarital agreement**. Some parents require a child to enter into a premarital agreement before receiving any distributions from a trust.

Imagination is the only limit on the variety of restrictions parents can place on a child's right to receive money. Keep in mind that someone—the trustee—needs to interpret, administer, invest, and make distributions according to the provisions of a trust.

A parent's choice of trustee is at least as important as the trust design. Space constraints prevent a full discussion of desirable trustee characteristics and attributes but consider the following questions:

- What degree of discretion do you wish to give the trustee to make distributions to children?
- How long will the trust last?
- What is the value of the trust assets?
- What type of asset is in the trust? If an operating business interest is to be owned by the trust, the choice of trustee may well be different than if the trust is comprised of investment assets.
- Should the trustee be a family member?
- Who will be entitled to remove the trustee and for which, if any, reason?

Step Three. After determining which restrictions they want in place, parents transfer the limited partnership interests or non-voting interests into each child's trust. At this point, the parent is giving a gift of the value of the limited interest to the child.

Unfortunately, parents with large estates often abandon the planning process at this stage because they believe they can only transfer their $10 million combined lifetime gift exemptions to their children without incurring immediate tax consequences. As we'll see in a moment, parents are often able to transfer as much wealth to children as they desire.

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The toughest question again arises: How much, when, and under which conditions should the kids receive the money?

Planning Can Benefit Charity

Before we leave our discussion of controlling access, there is one additional planning consideration we should mention. Under current estate-tax law, upon his or her death, one spouse can leave assets to the other spouse without estate-tax consequences. For most estates, taxes are assessed only upon the death of the surviving spouse.

If, during their lifetimes, parents are able to give their children (and other heirs) as much wealth as they want the children to receive, it is then possible to design an Estate Plan that gives the balance of the wealth upon the first parent's death to the surviving parent. When the surviving parent dies, his or her loved ones (i.e., their children) will have received (during that parent's lifetime) all of the wealth the parents wanted them to receive, and the balance of the estate can be transferred to charity upon the second parent's death. Some families establish private foundations or give money to other charitable organizations with the following results:

- The children receive what the parents want them to receive during the parents' lifetimes.
- The parents enjoy 100% of the wealth remaining as long as either parent survives.
- After both parents die, their wealth transfers to a charity of their choice, such as their own private foundation.
- The IRS gets nothing. For many parents and business owners, this is an Estate Plan design worthy of close scrutiny. For Doug Joyce, a man with strong charitable interests, this was the Estate Plan design that he chose to implement.

Question Three: *Which tools minimize the estate- and gift-tax consequences of transferring wealth?*

The key to transferring large amounts of wealth was discussed 2,000 years ago by the patron saint of Estate Planning attorneys, Archimedes. Regarding leverage, he observed, "Give me a place to stand and I will move the earth." Using leverage to move the earth—or to move your wealth—is the key to achieving noteworthy results. As we have discussed, each US resident can give away, during his or her lifetime, $5 million, as well as the current annual gift exclusion.

Doug Joyce's CPA (who was also a credentialed business appraiser) valued the business at $12 million, a conservative but supportable valuation. The company's stock was recapitalized into voting and non-voting stock. Based on current Tax Court case law, the CPA could justify discounting the value of non-voting stock (or a gift of a minority interest of the voting stock). In her opinion, the minority discount was 35% of the full fair market value of the stock. Thus, she reduced the price by 35% and was well on her way to leveraging the use of the Joyces' lifetime exemption amount.

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However, even with the 35% discount, a gift of 50% of the company (now reduced to approximately $4 million in value) would cause gift-tax consequences if Doug and his wife also gave gifts of equivalent value to each of the other two kids.

Like every other business owner, Doug was not particularly keen on paying taxes. So, he didn't, and he still gave away 50% of the company to Barry. He did so by using one of the biggest levers in the wealth-preservation transfer game—a grantor retained annuity trust (GRAT).

A GRAT is but one of many tools that many clever minds have created to produce or eliminate the estate tax. When these Estate Planning concepts and tools are combined with lifetime Exit Planning concepts and tools, they work to achieve an owner's lifetime and Estate Planning objectives.

The keys to success are as follows:

- Intelligent use of gift- and estate-tax reduction concepts.
- Time (because many of these tools work more effectively over time).
- Capable and coordinated advisors working in your interest.

How GRATs Work

After first obtaining a professional valuation of his company, Doug created a GRAT. A GRAT is an irrevocable trust into which the business owner transfers his or her stock. Doug transferred all of his non-voting stock into the GRAT, which represented 50% of the overall ownership interest in the company.

The GRAT must make a fixed payment (i.e., annuity) to Doug each year for a predetermined number of years. At the end of this time period, which is established when the trust is created (usually 2–10 years), any stock remaining in the trust is transferred to the children.

A gift is given when the stock is transferred into the GRAT. The amount of the gift is the value of the asset transferred minus the present value of the annuity that the owner will continue to receive.

In Doug's case, his advisors designed the value of the annuity to be equal to the value of the stock transferred into the trust. Therefore, Doug only gave a small gift of a few thousand dollars when he transferred his stock to the GRAT. To calculate this present value, the IRS requires the use of its federal midterm interest rate. The owner acts as the trustee (i.e., the person in charge of the management of the trust assets, in this case, the stock of the company).

Ideally, a GRAT includes an asset that appreciates in value and/or produces income (or grows in value) in excess of the federal midterm interest rate, which adjusts monthly.

Most successful businesses, including Doug's, easily exceed this IRS-mandated threshold. This is especially true when we design the gifting to take advantage of additional leverage in the form of using a minority discount on the original transfer of the business interest to the GRAT.

Here is where it really gets interesting: Doug's advisors matched up the amount of the expected S distributions payable with respect

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to the stock transferred into the GRAT (over $1 million per year) with the annual annuity payment (also a bit over $1 million per year).

Thus, at the termination of the four-year GRAT, all of the stock originally transferred to it remained in the GRAT (only the S distributions with respect to the transferred stock were needed to satisfy the annuity payments). That meant that all of the stock remained and was distributed to Barry, tax-free. Doug paid no gift taxes, and his income-tax liability during the four-year GRAT period was the same as if he had not given a gift to the GRAT.

Let's summarize what Doug did:

1. He transferred one-half of a business with a fair market value of between $12 million and $15 million to Barry over four years without using his lifetime exemption.
2. He continued to receive all of the income from the company during that four-year period.
3. At the termination of the trust (four years), the trust assets (all of the non-voting stock) were transferred to Barry.
4. Doug incurred minimal gift-tax consequences.

Conclusion

The business was eventually sold. Doug and his wife received far more than they required to maintain their relatively simple lifestyle, even though Doug had given away one-half of the business without gift-tax consequences. Doug and his wife subsequently made plans to establish a foundation and give additional wealth to the charities of their choice during their lifetimes.

This story illustrates how the effective use of GRATs and a host of other tax-saving and creditor-protection tools depend on understanding your objectives, for the business and for your family. The goal of these tools is to ensure your financial security while transferring the rest of your estate to whomever you choose, without tax consequences, and during your lifetime.

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