ESTATE PLANNING FOR THE BUSINESS OWNER

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Planning for Succession at Death

For the owner of a closely held business, death is often the last thing he or she wants to think about. However, failing to plan for death can negatively impact the future operation and success of the business. It can also provide an unintended benefit for the IRS. Finally, not deciding who will succeed to your business through proper planning could result in your business being owned by persons who are not suited or intended to be owners. In contrast, planning for succession of your business in advance can ease the transition and potentially provide considerable tax savings.

At a minimum, proper estate planning should be done to indicate whom should inherit your business at your death. In California, this is commonly done by means of a living trust. Much like a will, a living trust allows you to designate who inherits your assets. Living trusts have an advantage over wills because, if properly managed and funded (namely, ownership of your business is titled in the name of the trust), they allow an individual's estate to avoid probate. In California, the probate process can be time consuming and costly, and therefore it is generally preferable to avoid probate. Though it usually requires a probate, a will at least designates who should inherit your estate. If an individual dies without a will or trust, his/her assets will pass to those individuals as determined under the California intestacy laws. These individuals may or may not be the persons you would have chosen to succeed to the ownership of your business.

Trusts are very flexible and can be drafted to achieve both your non-tax and tax objectives. The terms of the trust can have the business interest held in trust for a particular person's benefit, such as your spouse or minor child, for a term of years or their lifetimes. A trust allows you to designate a trustee who will be the person responsible for managing the trust assets upon your death or incapacity. The selection of the trustee should be considered carefully, and it may even be desirable to name a special trustee to manage the business interest.

In addition to basic estate planning, where there are or may be multiple owners of a business it is generally advisable to enter into a buy-sell or stock restriction agreement between all of the owners. Such an agreement often provides mechanisms for succession of an owner's interest in the business upon his/her death. Commonly, this includes providing the surviving owners or the business with the right to purchase the deceased owner's shares. This provides the surviving owners the option to avoid taking on a new partner not of their choosing. Such agreements may also provide for mandatory repurchase of the deceased owner's, which can provide the deceased owner's family with liquidity needed for their future welfare. It may be advisable to consider having life insurance on the life of each business owner so that there is cash available to buy out the deceased owner's interest upon his/her death. Similar provisions can be included to deal with other events such as the divorce, bankruptcy or disability of an owner. Such agreements allow business owners to plan for possible events that may impact ownership or participation in the business before such events occur at which time one or more parties may be at a disadvantage. A buy sell agreement may be of considerable utility where the business owner desires to transfer his/her business interest to a key employee or fellow business partner. Where you have entered into a buy-sell or stock restriction agreement with your business partners, your trust should include specific provisions that reference the buy-sell agreement and require that the trustee abide by the terms of such agreement.

For many closely held business owners, planning for business succession at death also involves estate tax considerations. The estate tax may create particular problems for business owners because the business often constitutes a large percentage of the owner's net worth. Where this is the case, there may not be sufficient liquidity to pay the estate tax. Without proper planning to address payment of potential estate tax, the family members who survive may be forced to sell the business to pay the estate tax. A forced sale can be avoided through proper planning, which may involve the use of a buy sell agreement, life insurance or both. In addition, if the ownership of the business is properly structured in advance, the deceased owner's estate may qualify to defer the estate tax liability over a period of years.

In sum, proper planning with your legal and tax advisors for the succession of your business can facilitate the transition of the management of your business, protect your family's financial future, avoid unnecessary costs and time delays of probate and minimize any potential estate tax burden. In contrast, the absence of proper planning can jeopardize the future of your business and the financial security of your family.

Lifetime Transfers

The primary focus of most closely held business owners is on growing their business and increasing its profitability, and well it should be. However, there is no escaping the reality that at some point the ownership of the business will be transitioned to the next owner, whether such succeeding party is a family member, employee or third party purchaser. Commonly, business owners desire to transition their businesses to one or more family members. While transferring ownership to family members can be accomplished at death, there are often business and tax advantages to lifetime transfers. In general, there are several ways to make lifetime transfers of ownership interests, and each has its own advantages.

One option is to gift small interests in your business each year. Under current tax laws, you can transfer up to the annual exclusion amount (currently $13,000) per donee per year without being subject to U.S. gift tax or utilizing any of your lifetime gifting exemption (currently $1 million). For married individuals, your spouse can also make annual exclusion gifts. Where the interest gifted is a minority interest in a closely held business, the value of the transferred ownership interest is often reduced to account for the fact that the interest is a minority interest that likely has little marketability. Because the annual exclusion amount is relatively small, this method does not transfer significant amounts of wealth or ownership in any given year. However, depending upon the number of family members receiving ownership interests, over time this strategy can provide significant transfer tax savings.

The next step up the ladder is gifts in excess of the annual exclusion amount. Each individual currently has a $1 million gift tax exemption available for lifetime gifting. Gifting interests in your business allows you to avoid transfer tax on the appreciation of the transferred interest in the business that occurs after the gift. Thus, gifting larger amounts may be advisable where considerable future appreciation of the business is expected. Because of the reduced value that often applies to gifts of ownership interests in closely held businesses, lifetime gifts may afford considerable transfer tax savings. However, valuation discounts for closely held business interests is an area of focus for the Internal Revenue Service, and therefore an individual considering a gifting strategy should first consult with their tax or legal advisors.

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Many of the tax advantages of lifetime gifting can be enhanced through the use of certain advanced gifting strategies. Once such strategy involves the use of a trust known as a grantor retained annuity trust ("GRAT"). A GRAT is an irrevocable trust established by an individual who transfers a portion of his/her business to the trust. The terms of the trust require that the trust pay the individual an annuity over the term of years chosen by the individual. Provided the individual survives the chosen term, the assets remaining in the GRAT pass to the beneficiaries selected by the individual, commonly the individual's children or a trust for their benefit. The main advantage of a GRAT is that it transfers any appreciation of the business that occurs during the term free of transfer taxes, and often without the use of any lifetime gift exemption. Depending upon the appreciation of the business interest that occurs during the term of the trust, the tax savings can be substantial. GRATs have been particularly successful where the owner anticipates the possibility of a future sale of the business or taking the business public, though planning in advance of such events is required to maximize the effectiveness of such planning.

One additional technique for transferring ownership interests involves selling a portion of the business to a chosen family member in exchange for a promissory note. The note is then repaid over time, often using the dividends or net revenue received from the business. By selling the interest, the owner is able to transfer any future appreciation of the business free of estate or gift tax. Where the sale involves a minority interest in the business, the purchase price is generally reduced to reflect the market value of a minority interest. In addition, because interest rates are at relative lows historically, the chosen family member is currently able to finance the purchase on favorable terms. Where desired, the sale may even be structured in a manner that allows the selling owner to defer capital gains on the sale.

As these examples illustrate, there are many options for transferring your business to the next generation, and many provide the potential for considerable tax savings. While likely one or more of these options may yield strategic and tax advantages for most business owners, the benefits of lifetime transfers will vary for each individual and business. Which options or combination of options will be right for you should therefore be discussed with your estate planning attorney and tax advisors.