BIZ Spotlight ESTATE PLANNING

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More than One Way to Minimize Uncle Sam's Bite

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Successful family-business owners and others know that one way to stay ahead of the competition is to look beyond issues like meeting next week's payroll and consider long-term issues. That kind of forward-looking thinking should include sensitive issues like the most tax-efficient way to pass on your business to the next generation.

The simplest way would be to annually gift—or transfer to your designated successor—a predetermined ownership stake. As long as the fair market value of the stake is below an amount set by the Internal Revenue Code, currently $12,000 per year per giver, there's generally no tax on the transfer.

Once the gift-giver exceeds the $12,000 per year amount, he or she will begin eating into a $1 million lifetime exemption from the gift tax. After that is used up, the gift-giver has to pay gift tax to the Internal Revenue Service.

Gifting away your business in increments of $12,000 per year may take too long, says Rita Danylchuk, who is of counsel at the law firm Gibbons PC in Newark.

"Let's say a husband and wife own a business that's valued at $3 million," says Danylchuk. "If they each gift [$12,000 per parent per child] to each of their two children, they could only transfer $48,000 a year on a tax-free basis."

"Each year, the business should be revalued by an independent expert," adds Danylchuk. "If the business does well and is worth more, the percentage interest that could be transferred [while remaining under the tax-free limit] would shrink."

Danylchuk recently set up an alternative plan called an Intentionally Defective Grantor Trust (IDGT) for a New Jersey resident who owns a substantial spread of land and wants to subdivide the property and sell it to a developer for more than its current value. Such trusts enable gift-givers to reduce or even eliminate federal estate taxes that can reach as high as 45 percent this year. New Jersey levies its own estate tax that can reach as high as $182,000 on a business worth $3 million.

An IDGT creates a trust on behalf of the grantor's children or other individuals scheduled to take over a company or other asset. The trust issues the grantor a promissory note for the fair market value of the business. The grantor then receives money on an installment basis, typically with periodic payments composed of interest plus a balloon with the principal when the note is due.

The grantor is treated as the owner of the trust for income tax purposes—that's why the trust is called Intentionally Defective—and will be liable for any taxes on corporate, partnership or other income generated by the underlying business during his or her lifetime.

But that's a small price to pay, according to Danylchuk. "First, the grantor's income tax rate may be lower than the tax rates that are applicable to trusts," she says. "Also, if the business [and therefore the trust] produces any losses, they can usually be used to offset the grantor's personal income."

But the biggest advantage is the way an Intentionally Defective Grantor Trust can freeze the value of the business as of the date of the sale to the trust. This effectively shields the estate from being taxed on the growth of the business.

"Let's say someone owns a business that has a fair market value of $3 million on Dec. 31, 2007," says Danylchuk. "Let's also say the business grows and is worth $5 million upon her death two years later. If she leaves it to her son but does not create an IDGT, the entire $5 million value of the business, less the grantor's $2 million estate tax exemption, would generally be subject to federal estate tax."

That would mean a $1.3 million federal estate tax bill if the rate in 2009 is still 45 percent.

But if the owner had created an Intentionally Defective Grantor Trust, her estate should only pay tax on any uncollected amount of the $3 million promissory note. The taxable portion would be further reduced by the grantor's $2 million estate tax exemption.

But once a business owner sets up an IDGT, there's generally no turning back. "An Intentionally Defective Grantor Trust is irrevocable," says Danylchuk. "If you have second thoughts about your designated successor, you generally can't change your mind and appoint someone else."

Martin Abo, principal with Abo and Co. CPAs in Voorhees, says that business owners who want a bit more control while seeking to reduce their estate taxes can consider a Family Limited Partnership, or FLP.

"An FLP often takes the company and creates two classes of partners-owners," says Abo. "One class is the general partners, usually the current owner or owners, and the other is made up of limited partners, usually the children or other successors."

While the general partners keep control of the business during their lifetimes, the limited partners can often get a stream of income from the company. "The great thing about a Family Limited Partnership is that for gift-tax purposes, the limited partnership shares can usually be valued at a discount," says Abo.

"So at a one-third discount [to the fair market value of the ownership interest], a husband and wife with two children might be able to give away about $72,000 of ownership stakes each year, instead of only $12,000 apiece per child, without being subject to the gift tax or reducing their ultimate estate tax exclusion."

One reason for the discount is that a minority stake in a company is generally not worth as much as a majority stake, says Abo. Also, if the company is privately held, there isn't much of an outside market for the ownership shares.

One drawback of this gifting technique is that the business and the ownership shares being gifted need to be revalued each year. Abo says hiring an independent valuation expert can reduce the chances of an IRS challenge.

"Also, if you use an accredited valuation expert and attach the appraisal to the gift-tax returns, the IRS generally only has up to three years from the date of your gift-tax return filing to challenge your computations," he says. "If you don't use an expert, there may be no statute of limitations on an IRS challenge."

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