



Welcome to *Trust Connection*, our monthly newsletter highlighting Trust news and information. Each month we will feature timely articles of interest.

## About Us

At Halliday Private Trust, it is our mission to assist our clients in the process of providing solutions, specifically through a wide range of financial advice.

Since 1982, we have utilized a full spectrum of financial services to help our clients navigate every major hurdle in their financial lives. Because we are an independent financial services firm, we utilize an open architecture approach to locating the most suitable investment options for our clients.

Our role is to help clients make smart decisions about their money. We understand that each client has unique needs and requires personalized solutions based on their goals, objectives and concerns.

## Don't Fumble the Handoff

The American Dream: owning your own business, being your own boss, passing the family business to heirs or selling it for a big payday. Most people have a hard time accomplishing the latter part of this effectively. In fact, only about half of business owners have succession plans. Why is this so? In most cases, owners are too busy running their businesses to consider the details of succession. Others avoid it because, like many estate planning issues, it hits very close to home emotionally and can be difficult in regard to family dynamics.

This topic will be addressed with a focus on three categories: transaction, tax consequences, and techniques. The objectives of business owners vary widely, and so do the techniques that can be utilized to aid with the transaction financially. This article will therefore focus on the "handoff" to the next generation.

There are two key factors in transaction: to whom (family, employees, or third party) and when (during life or at death). For this reason, transfers to family, during life and at death, will be the focus of the "handoff".

The transfer of a significant asset by gift or estate creates tax consequences. In some cases, the transfer may also involve multiple generations and trigger another tax called generation-skipping transfer tax.

Gifts may be made outright or in a trust when control of the proceeds and ongoing tax and asset protection are desired for future generations. Grantor Retained Annuity Trusts (GRATs), and sales to Intentionally Defective Grantor Trusts (IDGTs) are often successfully used for this purpose. Many times these techniques are coupled with other structures such as Family Limited Partnerships to unitize and create minority interests for subsequent transfer.

It's helpful here to think in three layers: annual exclusion, applicable exclusion amount, and over the exclusions. In all transactions with family members, the intent is to get the biggest bang per buck of exclusion, so fractionalization of business interests is a very common first step. This involves giving away minority interests in the company that, when the lack of control and lack of marketability are considered, bring discounts in market value typically in the 33 to 40 percent range. The reason for this is that fair market value, when based upon a comparable sales approach, would not look at a 10 percent interest in a business as the same percentage of fair market value; rather, it looks at what a buyer would be willing to pay for only a portion of the business, which is closely held and thus lacks marketability and control (i.e. even as a 10 percent owner, that owner's say is negligible when someone else owns 90 percent). The combination of these factors, as well as the illiquidity of the underlying assets,

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## A LOCAL TRUST SOLUTION

Call us today at (800) 786-1598 to learn more about working with Halliday Private Trust.

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key person considerations, built-in low-cost basis of the assets, and other factors, all serve to further restrict the attractiveness of the shares to an outside buyer and therefore enable the discounting of the fair market value. These techniques have been so successful that the IRS recently sought to rewrite the tax regulations to end or limit the use of the technique, which has many years of success in valuation challenges in the tax courts. These proposed changes drew such harsh criticism and thousands of challenges by experts in the field when opened for public comment that they have been dropped with no further action expected for the foreseeable future. This will be called a “minority interest discount” for simplicity of discussion.

The annual exclusion is the amount that can be given away gift-tax free from each donor to each donor every year: \$15,000 in 2018. So using a minority interest discount, even giving shares outright to children means that more shares can be transferred for the annual exclusion amount. If the company does not have many shares, and thus the per-share price is high, consider recapitalizing with a stock split to be able to lower the per share value and making it easier to get a gift closer to the target amount desired.

The second layer is the applicable exclusion amount, which is the amount each person may transfer free of gift, estate, and even generation-skipping transfer tax. In 2018, this amount is \$5,600,000 — and up to double that for couples or surviving spouses, where the first spouse died in 2011 or later and did not use any or all of his/her estate tax free amount. Again, even outright gifts of what should be \$9,333,333 worth of shares as a percentage of fair market value, when given a 40 percent minority interest discount, would be treated as worth only \$5,600,000 under the willing-buyer, willing-seller rule.

The third layer takes a closer look at amounts over the exclusions. Here the client either needs to pay gift tax at 40 percent or engage in zero-value gift transactions. Two popular techniques are the GRAT and the sale to an IDGT. Both of these techniques and others such as intra-family loans and private annuities rely on the same modus operandi: exchange an equity interest that is expected to grow for a fixed income interest of equivalent value. Since this is an arm’s length transaction for equal value, no gift is triggered, but all growth over the fixed income interest rate is essentially transferred gift-tax free. This works particularly well in a low interest rate environment such as that being enjoyed at the present time. So, for example, if mother gave to daughter \$1,000,000 worth of the family company shares in return for a \$1,000,000 note paying two percent, the daughter would pay back \$1,020,000, not including time value of money or compounding. But, if the shares increased 20 percent in the same period, then the daughter would have \$1,200,000. After paying back the \$1,020,000, she would be up \$180,000 per million with no gift tax consequence. These techniques often layer time value discounts on top of the minority interest discount, and the leverage can be dramatic.

There is no one technique that is right for everyone, nor one best technique, since the factors that lead us to the appropriate technique are as unique as the business owners themselves and the family and business dynamics. Make sure to align yourself with an experienced team of educated financial advisors, tax advisors, and legal advisors to make sure you don’t “fumble the handoff” in what is often the single most important transaction in a business owner’s life.

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