Pre-Transaction Wealth Planning for Business Owners

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Since its founding in 1997, Gresham Partners has started working with many business owners soon after they sold their closely held business. The successful sale of a business should be cause for celebration, but some of these former business owners were caught off guard by feelings of regret over the process and other significant emotional issues that arose following the sale. Other former business owners were surprised to learn after the sale that they could have avoided some related tax costs if they had implemented advanced wealth planning strategies prior to the sale.

These experiences highlight the importance of pre-transaction wealth planning for business owners. Even in situations where an owner is not currently considering a sale, thoughtful planning now can ensure that the owner and their family are properly prepared for the process and have in place a plan that will achieve their long-term objectives.

Navigating Non-Financial Issues

For a successful business owner, their company may represent their life's work and their family's livelihood, and thus be much more than a financial asset. Such an owner typically has a strong emotional bond to their company, and selling the business can be a bitter-sweet event. Having decided to sell, the owner needs to think through a myriad of non-financial issues, such as "Do I want to stay involved in the business?", "What am I going to do with my life after the sale?", and "How might the sale impact my family?".

This last question can be particularly difficult if other family members are involved with the company and desire to continue working in a leadership role, which may not be an option if the company is sold. Even if the owner's family is not interested in working in the business, the owner may have concerns about employees and how they will be affected by the sale.

Other conflicts can arise when the owner's children or grandchildren have unfounded expectations about the proceeds that a sale may generate. If the owner has never discussed their wealth transfer goals with the family, their descendants may have assumptions or beliefs that differ dramatically from the owner's views on the amounts or timing of any wealth transfers. This issue can be especially sensitive if the owner intends to divide assets unequally among children – for example, if some children are more financially successful and the owner does not feel they need additional assets – or if the owner intends to leave the majority of their wealth to charity and has not discussed this plan with their family.

These types of emotional issues require careful thought to ensure that the sale itself does not cause family discord. In addition, the owner should have an idea of how they will spend their time after the transaction closes. A wealth advisor can assist the owner and their family in thinking through some of these concerns and, when appropriate, bring in experts who can help navigate family dynamics and the psychological issues involved with selling a business.

Planning Now for the Future

The estate tax arguably constitutes a deliberate social policy to prevent the accumulation of inherited wealth by operating in a confiscatory manner over successive generations. For business owners who want to minimize these impacts of the estate tax and maximize the amount of wealth they can pass to their children and further descendants, planning early in the process is vital. As the value of the business increases, it becomes more expensive from a tax perspective to transfer wealth to future generations. Once a business owner has achieved financial security and is comfortable transferring assets to others, planning three or more years before a sale – or, preferably, the prospect of a potential sale – is an ideal time to move future appreciation out of the owner's estate.

As background, the federal government imposes a tax on transfers during life (the gift tax) or at death (the estate tax) to individuals or trusts for their benefit. The federal government also imposes a second layer of gift or estate tax, called the generation-skipping transfer (GST) tax, on transfers that skip a generation, such as a transfer that skips a living child and goes directly to a grandchild or a trust for their benefit. In addition, various states impose their own gift, estate and GST taxes on transfers of wealth to beneficiaries and heirs. Collectively, these taxes are generally referred to as "transfer" taxes.

The current federal transfer tax rate is 40%, with the first $5.25 million (for 2013 and indexed for future inflation) of assets transferred by a donor exempt from this taxation. Proposals to change the rate and exemption amount are ongoing, and any planning needs to reflect current thinking regarding the prospects for such changes.

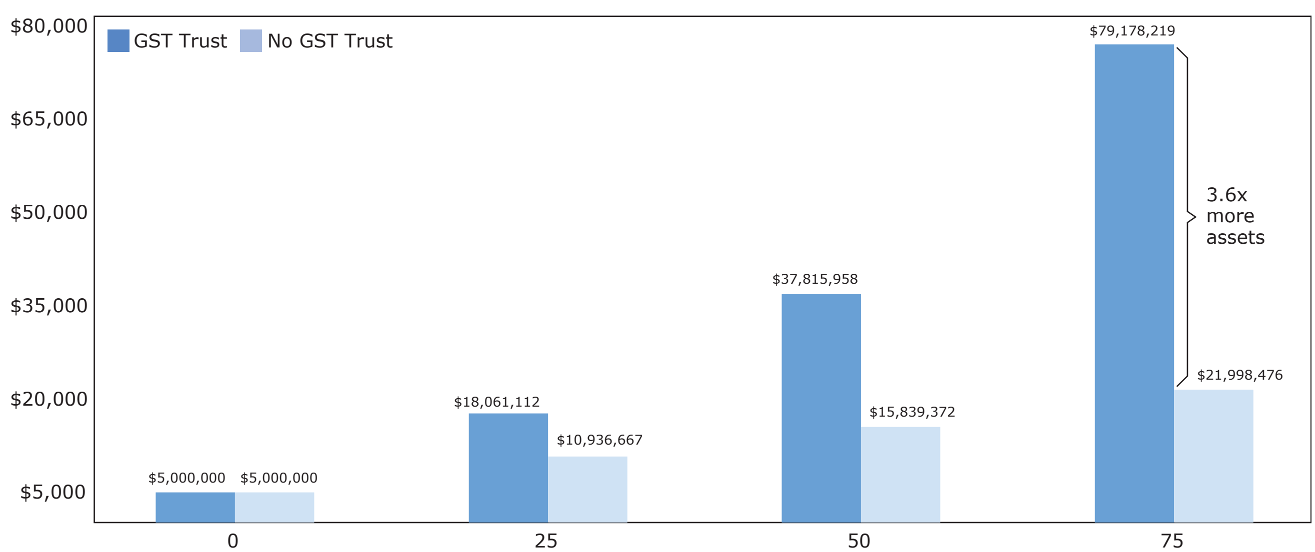
The two most common techniques used to maximize wealth transfer planning involve generation skipping transfers and current valuation freezes. The goal behind both approaches is to shift appreciation in assets to future generations, without the future imposition of estate tax on such appreciation. While transferring an interest in the business to children can result in significant estate tax savings for the owner, GST planning is compelling because the owner can transfer value to more remote descendants such as grandchildren and great-grandchildren with fewer levels of intervening estate tax. By leveraging an owner's gift and GST tax exemptions to create and fund a GST Trust, the gifted business interest and its future appreciation can be exempt from estate taxation in both the owner's estate and in their heirs' future estates.

Generation Skipping Transfer Trust (GST Trust)

A GST Trust is one method to take advantage of an owner's GST tax exemption. As noted above, the GST tax restricts persons with substantial estates from skipping their children and passing assets directly to their grandchildren and later descendants, without incurring a significant tax penalty. Assets that skip to the grandchildren's level would be subjected to two levels of tax – the regular estate tax and the GST tax – as if the assets had passed through the children's estates on their way to the grandchildren. The total combined tax can exceed 70% for generation-skipping transfers.

The following example illustrates the benefits of a business owner transferring to a GST Trust an interest in their company worth $5 million today, assuming: i) The company's value grows at an annual rate of approxi-

Initial $5 million business interest sold for $10 million after 5 years, growing for 70 years thereafter at 3% after taxes and spending, with a 40% estate tax rate applicable.



mately 15%; ii) In five years, the company is sold, and the business interest held in the GST trust is worth $10 million; and, iii) The GST Trust is structured as a grantor trust, so the business owner (the grantor) pays the income tax generated by the trust's assets, allowing the trust to grow without reductions for income taxes.

It is clear that GST tax planning can result in a substantial increase in the value of future assets if successive estate taxes are avoided at a 40% rate, or an even higher rate if state death taxes also are imposed. Over a 75-year period, this GST planning can produce for the benefit of the owner's heirs over 3.6 times the amount of assets they would be have without the GST planning. Without the drag of multiple levels of estate tax over long periods, appreciation can dwarf the initially transferred value. Note that while the benefits of the GST Trust are leveraged by creating a pool of assets for grandchildren or more remote descendants, the owner's spouse or children can also draw upon the GST Trust, if necessary. That is why gifting an owner's business interest before a significant increase in value is so powerful – the future appreciation is shifted to the beneficiaries before it is subjected to wealth transfer taxes at the owner's level.

This is just one example of planning strategies that are available to transfer ownership interests in a tax efficient manner. Depending on the owner's financial needs and desires, rather than making an outright gift, they may choose a different structure where they sell an interest in the business to a GST Trust in exchange for a promissory note. This allows the owner to transfer only the future potential appreciation in the transferred business interest, rather than make an outright gift of a portion of the business today.

We have worked with many business owners and their legal counsel to design and implement strategies like these.

Importance of Current Contingency Planning

Even before a business owner feels financially secure and ready to transfer assets to others, other types of pre-transaction planning are important. For many private business owners, the company is an illiquid asset representing the majority of the family's wealth. This fact highlights the importance of current contingency planning, particularly if one or two owners or employees are integral to the ongoing success of the business. Adequate personal life insurance is needed in the event of the death of one of the owners, or a key employee, to protect against a forced liquidation of the business. If a business has multiple owners, buy-sell agreements should be in place to ensure there is a succession plan and adequate liquidity for the deceased owner's share of the company. Additionally, business owners should examine their personal liability coverages and assess the need to purchase excess liability ("umbrella") coverage to ensure they have adequate liability protection from potential creditors in the event of a lawsuit.

Estate planning documents should be reviewed to make sure they comply with current law and bequeath assets in amounts and to heirs as intended. For example, the plan may not reflect the owner's current objectives and inadvertently exclude certain heirs or include others who they no longer wish to receive bequests. In addition, a business owner may have significantly increased their net worth since their estate plan was drafted and not realize that in the event of their death younger beneficiaries will receive substantial assets outright rather than be retained in trust for their benefit. Assets retained in a lifetime trust are often preferable to outright bequests or trust distributions to beneficiaries at pre-determined ages; lifetime trusts provide the beneficiary, and business interests held in trust, creditor and marital protection against contingencies that could force a liquidation of the business interests.

If the owner's closely held business interest will pass to a trust upon their death, the trustee(s) should have experience in dealing with private companies, as this may represent the largest or possibly sole asset in the trust. If the trustees are not comfortable as fiduciaries continuing to hold the private business interest in the trust, they may try to liquidate this interest or even attempt to force a sale of the entire company in an effort to diversify the trust's assets. Further, without proper advisors or guidance from an experienced business leader that is familiar with the industry, the trustees may not extract maximum value in the sale.

More generally, trust provisions should be reviewed to ensure they are flexible to allow for changes in trustees in certain situations, such as if the trustee and beneficiary have a dysfunctional relationship and are unable to work together or if a corporate trustee needs to be terminated for poor performance.

Charitable Planning

For business owners who are philanthropically inclined, the sale of a business is an opportune time to consider implementing charitable giving strategies that can also reduce income and/or wealth transfer taxes. For example, a Charitable Remainder Trust can allow a business owner to convert a low-basis interest in their company into a more diversified portfolio with reduced gift and capital gains taxes, while receiving an income tax charitable deduction. The remainder trust pays a taxable annuity to the owner, providing an income stream for their lifetime or a set term of years, and at the termination of the trust the remaining assets pass to the charity.

Another planning vehicle, a Charitable Lead Trust, benefits the charity immediately with an annuity stream for a term of years, with any appreciation over a set amount passing to the owner's heirs after the lead trust's term. The lead trust can be constructed so that the owner receives a substantial income tax deduction upon its formation. The lead trust is primarily a charitable giving strategy, so it is best used for owners who have significant charitable intentions and/or whose heirs have sufficient other resources.

Conclusion

Pre-transaction planning can yield many benefits to a business owner, including: i) Ensuring that their family is financially protected if some unexpected negative event happens to the owner or their business before a sale; ii) Reducing potential family conflicts that may arise as a result of a potential sale; and, iii) Minimizing the impact of future gift and estate taxes. While it is possible to engage in planning strategies after a transaction has been announced, or even after it has closed, the largest benefits can be achieved by planning before a transaction is even contemplated and before significant appreciation in the business is realized.

The key is to get a business owner to think about their long-term goals years before a sale may occur. We have been successful in getting some business owners to do this pre-transaction planning by asking them the right questions and helping them understand the value and practicality of such early planning.

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