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Trust & Estate *Insights*

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Key Takeaways:

- Utilizing certain estate planning strategies prior to a liquidity event can result in significant wealth preservation and tax savings.
- Timing is everything--the earlier you plan, the greater the opportunity to maximize your gift.
- Managing expectations and communicating with family members is critical in order to reduce the stress on family relationships.

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Pre-Sale Planning: Putting the Horse Before the Cart

When a business is up for sale, closing the deal is often all that owners think about. Owners may feel that taking steps in anticipation of a sale is like "putting the cart before the horse." Not so! A truly efficient sale incorporates tax planning opportunities that can result in significant income, gift and estate tax savings that may be lost once the deal is closed.

Effective pre-sale planning can minimize both income and estate tax consequences. Business owners may engage in certain tax planning strategies to minimize income tax on the sale. Gift and estate tax savings can be achieved by transferring part of the value of the owner's business to family members, trusts or other entities at a lower valuation prior to the close. When contemplating the sale of a business, owners should make sure that the transaction structure complements their family's financial goals and objectives.

Structure of the Sale

The structure of the sale presents income tax considerations for the buyer and the seller, considerations which will affect not only the sales price but also the structure of the deal. For example, the parties may negotiate whether the transaction will be a sale of stock or assets, whether the consideration will be stock, assets or a combination of both and if the restructuring of the company will trigger income taxes. During the deal structuring and negotiation, business owners are often consumed by the transaction details. However, estate and tax planning can be critical to the long-term wealth of the family and need not slow the transaction.

Valuation

In many cases, the valuation of a business obtained well in advance of a sale may be significantly less than the eventual sales price. Because estate and gift taxes are based on the fair market value of assets at the time of transfer, taking advantage of lower valuations allows owners to shift wealth to family members at a lower cost.

The cornerstone of any pre-sale planning is the appraisal. Appraisals of closely held business interests often incorporate discounts for lack of marketability and lack of control. While the IRS may challenge overly aggressive valuations, substantial discounts on the value of interests in privately held operating businesses have survived IRS challenge. However, once a business is sold to an unrelated third party, the opportunity to apply a discount to the sale price disappears, so pre-sale transfers can potentially transfer greater wealth. Moreover, transfers should be completed as far in advance of the sale as possible. The closer in time to the sale a transfer occurs, the more likely the IRS can successfully argue that the sale price reflects fair market value at the time of the gift. A gift made with a low valuation long before a liquidity event can accomplish far more from a transfer tax perspective than many complex estate planning strategies implemented later in time when the value of the business has grown.

How late is too late?

In an ideal world business owners would complete desired gifts of business interests long before a liquidity event is on the horizon. In reality business owners are rarely aware of the time sensitivity of planning opportunities until the sales process has begun. If a letter of intent has been signed or if a buyer has agreed to buy shares at a certain price, it is difficult to argue that the shares have a significantly lower price for purposes of transfers by gift. However, a valuation discount may be achievable even after negotiations have begun since certain conditions of the offer may not be met and the deal may not close. It is critical to consult with tax and legal advisors as soon as possible to determine whether pre-sale gifting makes sense.

Maintaining Control

Many business owners are comfortable with making gifts of the value of their business interests but wish to retain control over the transferred shares. If the business owner makes a gift but retains certain rights over the property or the right to vote certain types of shares, the value of the transferred interest will be brought back into his estate for estate tax purposes. However, some strategies can allow the business owner to retain certain controls. These include gifting non-voting interests, placing shares into a family limited partnership or gifting the shares into a trust and designating the business owner as the investment advisor of the trust.[1]. Sophisticated attorneys who routinely structure these types of transactions can usually find a solution to allow the business owner to maintain a desired level of investment control without jeopardizing the intended tax benefits.

State Income Tax Considerations

Business owners who live in states with high income taxes sometimes consider changing their residency for income tax purposes prior to a sale to reduce or avoid state level income taxes. The requirements to establish a new domicile for income tax

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[1] This strategy may only be available for certain types of trusts and for certain business interests. For example, the business owner may not retain the right to vote shares of a controlled corporation (where the business owner controls 20% or more of the voting shares) or the value of the shares will be included in his estate for estate tax purposes. It is critical to obtain the advice of counsel as to whether allowing the business owner to act as investment advisor is advisable.

purposes can be varied and complex and it may not be possible to achieve a change in domicile prior to the close of the transaction. Also, business owners may use certain types of trusts to defer or possibly eliminate state income tax. These trusts can be quite complex, however, so particular care should be taken in selecting experienced counsel.

Gifting Strategies

Numerous strategies to transfer wealth using discounts exist, ranging from a simple outright gift of shares to a complex leveraged structure. Of course, determining which strategy to use requires a thorough understanding of the family's goals and detailed analysis by the business owner's tax and legal counsel.

Gift of Shares. A business owner can make gifts of shares to family members or trusts, and thereby shift the value of those shares (and any future appreciation) out of his or her estate for transfer tax purposes. Under current law, the gift tax exemption is $5,000,000 per person in 2011 and $5,120,000 in 2012. Absent action by Congress, beginning in 2013, the gift tax exemption is scheduled to decrease to $1,000,000 per person. Accordingly, in 2011, a business owner and his spouse can transfer up to $10 million worth of stock without generating a gift tax.

The following chart illustrates the potential tax consequences of making a gift of shares prior to a sale of a business versus holding onto the shares and paying estate taxes at death.

Transferring Business Interests Now vs. At Death

	Shares Gifted Now	Shares Retained in Estate
Value of contemplated gift (40% of business)	$5,000,000[1]	$5,000,000
Gift Tax Due	$0	n/a
Growth	6%[2]	6%
Value at death of 40% interest (20 years later)	$16,035,677	$16,035,677
Total gross estate[3]	$24,053,516	$40,089,193
Estate tax	$7,018,731	$12,281,218[4]

1. Assumes a value determined by appraisal with no valuation discounts. If discounts did apply, it could mean a transfer of more shares and a better wealth transfer result.
2. Assumes 6% growth annually and does not account for income taxes payable upon a liquidity event.
3. For simplification, assumes only asset of estate is remaining business interest.
4. Assumes assets generate a federal estate tax at a 35% rate and does not take into account possible additional state estate tax. Note that shares given during lifetime will receive donor's carryover basis while shares included in the gross estate will receive a step up in basis to date of death values.

One common strategy is making a gift of shares to an irrevocable "grantor trust", so the shares are removed from the business owner's estate for *estate tax* purposes but he or she is treated as the owner for *income tax* purposes. The result is that all gains, losses, credits and deductions generated by the trust assets flow back to the grantor. Accordingly, upon the sale of the business, the grantor will pay all of the income tax generated by the sale. Why is that a good thing? By paying the capital gains tax on the shares owned by the trust, trust assets continue to grow and compound free from income tax. The grantor is essentially making ongoing transfer tax-free gifts to the trust. Of course, business owners will need to have sufficient other liquid assets for this structure to make sense.

Sale of Shares to a Trust. A trust for the benefit of family members can purchase shares from the business owner, with the price determined by an appraisal.[2] Typically the trust pays for the shares by issuing the owner a promissory note bearing an interest rate based on monthly IRS tables (which are historically lower than commercial rates). If the sale price is for full fair market value, then there is no gift, and thus no gift tax. If the trust's assets appreciate at a rate higher than the interest rate on the note, there will be excess value remaining in the trust after the note is fully paid off, and that excess value will escape transfer tax. Typically, the trust is structured as a grantor trust, as described above. As a result, the sale to the trust does not generate capital gains tax for the business owner because he or she is considered to be selling the shares to himself or herself. Similarly, the interest payments on the note are not income to the business owner. In addition, the owner remains liable for the income tax liability of the trust, thereby allowing the trust assets to compound free from income tax.

GRAT. With a Grantor Retained Annuity Trust (GRAT), the grantor funds the trusts with shares of the closely held business. The trustee of the GRAT distributes an annuity (a fixed amount determined at the outset) to the grantor for a term of years, after which any assets remaining in the trust will pass to the remainder beneficiaries (often the grantor's children). Typically, the GRAT is structured so that the present value of the annuity payments made to the grantor will actuarially equal the fair market value of the property contributed to the GRAT such that no gift tax is due. If the shares in the GRAT appreciate at a rate that exceeds the IRS's growth rate assumption (1.4% in November 2011), all appreciation in excess of this threshold passes to the beneficiary free of gift tax.[3] GRATs are also grantor trusts for income tax purposes, so the potential for tax-free

[2] If there is no existing trust with assets to purchase the shares, a new trust can be created and "seeded" with a gift of enough assets to give the trust a reasonable level of equity. The gift to this trust could generate gift taxes. Generally, the grantor will fund the trust by gifting assets that represent at least 10% of the purchase price.

[3] However, if the grantor dies during the term of the GRAT, all of the assets of the GRAT are generally includible in the grantor's estate for estate tax purposes, thus negating any tax advantages the GRAT would otherwise provide. GRATs are therefore typically set up with short terms—two or three years—to minimize this "mortality risk."

compounding and the potential for taxable income without liquidity, both noted above, apply to GRATs as well.

Charitable Planning. If the business owner is philanthropically inclined, a transfer of shares into a foundation or charitable remainder trust prior to a sale may generate an income tax deduction and possible deferral or avoidance of income tax payable upon the sale. For example, if the business owner transfers shares to a private foundation prior to the transaction, the foundation would then sell the shares to the ultimate buyer. The business owner would receive an income tax deduction equal to the fair market value of the shares on the date of the transfer (which would likely be established by an appraisal and would be subject to the deduction limitations applicable to gifts to private foundations) and the foundation would avoid a large capital gains tax upon the sale (although would be subject the excise tax on net investment income).

In most cases, business owners will not want to transfer shares to a charitable vehicle far in advance of the transaction due to the risks associated with a foundation holding illiquid private stock. However there are also risks if they wait too long and transfer the shares when a sale is imminent. Potential minefields to avoid include making a prohibited "assignment of income" and jeopardizing the avoidance of gain upon the sale if the shares are transferred to a foundation after an enforceable contract has been executed. To avoid those issues, and to optimize the charitable income tax deduction, some business owners choose to wait until after the sale of a business to transfer post-sale proceeds to a charitable vehicle even though they may be paying capital gains tax on the sale. If charitable giving is a goal, it is critical to work with experienced tax and legal advisors.

Conclusion

Estate and income tax planning prior to sale (the horse before the cart) will require the time and attention of the business owner but can result in significant tax savings for the family. UBS can provide analysis and assistance with this critical component of pre-transaction planning.

--*Ann Bjerke*
Senior Wealth Strategist

Prepare to Be Tested: The Role of Family Dynamics in Selling a Business

Remember the days when the mere thought of selling your business put a smile on your face and lightness to your step? What happened? How did joy get replaced by dread? How did the straightforward path to selling your business get so twisted and convoluted?

Selling a business is difficult. Most business owners understand that, but only to a degree. They understand that the sales process will strain their relationship with a spouse and children both in and out of the business. They know that new liquid wealth can seriously damage family relationships. They understand that filling 60 hours a week with things they find engaging and rewarding will be difficult. And they're aware that on some days they will wake up and ask: "Should I be selling?"

Often, business owners dramatically underestimate the amount of stress on relationships, the challenges of finding new purpose and the emotional cost of second guessing. Since they underestimate, they under-prepare.

Here are some suggestions on how to better prepare yourself for the sale of your business.

Find a mentor

It is most helpful, without question, to have someone who can sit by your side and help you do your best thinking. Look for someone who offers objectivity and neutrality and whose interests are in no way linked to the successful sale of your enterprise. You're looking for the opportunity to say, without any hesitation:

- "This is what I'm up against…"
- "What you think of this approach..."
- "It backfired - I'm not sure what to do next."

Unfortunately, the pool of people who can take on this role tends to be pretty small. Most of your usual candidates aren't right for this job. You don't necessarily need someone who's been there before, but that's not a bad place to begin looking.

Start Discussing (and keep discussing)

Families assume everything and discuss nothing. Business sellers, unfortunately, assume even more and discuss even less.

Some owners assume that selling the business is good for family harmony. They assume that the years of tension created between family members who were included in the business and others who were left out will be erased with an equal payout for all. To the negative, others assume that talks with their children about the size of the new wealth will slow down their efforts to create and lead independent, value-driven lives. These are big assumptions and usually way off base.

So, instead of making assumptions, ask lots of questions. Use your gut as your guide (isn't that what got your business to where it is today?). For example, if your relationship with a family member in the business is beginning to ‘feel different’ (“It’s not like the way it used to be between us”) use that observation as a stepping off point.

Try opening the conversations with honest curiosity:

- “I want to check something out with you, I’ve noticed...”
- “I could be wrong about this, but...”
- And with your children: “This is my best thinking about how to handle our wealth, but I want to know what you think.”

Prep the marriage

Absence makes the heart grow fonder, or so it is said. In fact, the absences that the family business required may have even helped strengthen your marriage as it forced you to give each other a little space.

But absence, of course, is not the issue in your future; togetherness is the issue. The question moves from: “How do we make more time for us?” to “What should we do today?” Figuring out the proper balance in this new equation takes time, so be patient (Think in terms of many months and not a couple of weeks).

To reduce pressure on your marriage and increase the ‘curb appeal’ of more closeness, try the following:

First. Resist any temptation to ask your spouse to consider changes they can begin to make in their life, so they can prepare to accommodate the upcoming changes in yours.

Second. Repeat daily: “Taking care of me *(your happiness, value, and place in the world*) is my job today and will always be my job.” In other words, don’t begin fantasizing about outsourcing this care-taking responsibility to your spouse.

Stay in Contact

Anxiety increases as the sales process unfolds. It increases dramatically for those whose lives and dreams have been closely tied to the business, including a wide swath of extended family who never stepped a foot inside the business. As these people, become more anxious, they will likely make more demands on you to alleviate their anxiety. Stay visible and be available. Don’t make it difficult for them to find you. No hiding.

Stay true to your principles and goals

Be careful. Too often, business owners compromise their core, well-thought positions about the sale for an anxious family member: the child in the business, the share-holding third-generation cousin who has the ear of leadership and everyone on the ghost payroll. They start off with a few tweaks to help someone feel better, but small adjustments can turn into wholesale capitulations.

You know your family and you should expect that their emotional connection to the business will prompt new strategies for getting what they want from you. In these challenging moments, you'll need a solid plan for responding to any family member's heart-wrenching pleas and genuine fears. Begin building the plan by analyzing your experiences with those who have previously tested one of your core positions.

- What specific threat drove this person to seek relief from you?
- What part did you play in raising this threat and increasing this person's anxiety?
- What rational, well thought-out claims did this person make?
- What made it difficult for you to be objective and neutral?
- What setting allowed you to be objective, neutral and do your best thinking with this person?

These suggestions will not eliminate the stress that comes with selling the business, but they might improve your ability to handle it. Good luck.

--*Michael J. O'Malley*
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