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The Importance of Estate Planning for the Closely Held Company

Why is estate planning so important for the closely held company? Let’s consider two scenarios:

> Scenario 1
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> You start a business that is doing less than $1,000,000 in sales in its first year, but you know you are onto something valuable. The company sales over the next 30 years grow to $200,000,000 and generate over $10,000,000 in free annual cash flow.
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> You initiated estate planning when you were young. At the time you turned the company over to the next generation, just prior to your death, the value of your estate was below the level at which it would be subject to estate taxes.
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> Scenario 2
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> The facts are identical to scenario 1 above, but you did not undertake estate planning until the company was more mature.
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> Your children are struggling with a ***$40,000,000 estate tax***, and they may have to sell the business to pay the estate tax.

In scenario 2, how can your children avoid the estate tax without losing control of the company?

We will assume that you have elected the provisions of Subchapter S of the Internal Revenue Code and that your company is an S Corp for income tax purposes, or it is operating as a limited liability company. Either way, you are paying only one level of tax. You definitely do not want to be a C Corp, which is taxed under Subchapter C of the Internal Revenue Code and thus is subject to two levels of tax. The company pays one level of tax on its net income, and you pay another level of tax on distributions to you from the company.

Back to how to accomplish the estate tax savings…

Reorganize the stock structure of your company to Class A Voting and Class B Non-Voting Stock!

First, you reorganize the structure of your company so that it has two classes of stock. One is a Class A Voting stock, which represents 1% of the equity of the company, and the second is a Class B Non-Voting stock, which represents 99% of the equity of the company. The shares must be identical except for the voting rights. Otherwise, you'll breach the two classes of stock rule that is applicable to S Corps. For whatever reason, the IRS chooses to treat two classes of stock as "one class" of stock if the only difference between them is voting rights.

Note - Although I am writing this article on the assumption that you have an S Corp, the same principles, with minor variations, are applicable to limited liability companies.

Second, you exchange all of your shares of the common stock of the company that you currently own for all of the Class A Voting and the Class B Non-Voting shares. You keep the Class A Voting shares and use the Class B Non-Voting shares to reduce your estate through gifting.

Gift-Giving Plan

Third, you start an annual gifting program of the Class B Non-Voting shares to members of your family. If your children are minors, you'll use a minor's trust to obtain the benefit of the $14,000 annual gift tax exclusion for each of your children.

Discounting

Fourth, you use the benefit of "discounting."

What is discounting?

If a company goes to Wall Street to obtain an investor, the investor will not be willing to pay the full value for the company's Class B Non-

Voting shares because he or she will not be able to either sell the shares on a market (thus, it is an illiquid investment) or control the investment.

Let's say that the company is worth $20,000,000 and it wants to sell 20% of its shares for $4,000,000. The investor will insist upon a discount, say 25%, because his or her shares will be illiquid and he or she will not be in control of the company. Thus, the investor will be willing to invest $3,000,000 for a 20% interest in the company for the risks he or she is taking.

This is called "discounting," and tax attorneys have been using it successfully for years in family-held businesses. Yes, the IRS does not like the concept and has argued the point in court, but the courts have held that the gift tax laws say that the fair market value of a gift is the standard that the statute requires be used for gifts, family included.

Translate this concept of "discounting" into a family situation, and a 25% discount means that each annual $14,000 gift is actually valued at $18,666.

Over a period of years, when your company is young and far less valuable than it will become, you can transfer a substantial amount of equity on a tax-free basis.

So far so good for your company when you start early. But what if you didn't start early, and the company has grown so that the annual gift-giving plan has *some* value but you need *more* to spare your children the "big taxes" problem that arises in scenario 2 above?

The Grantor Trust

What is a grantor trust?

A grantor trust is a trust that you create and in which you retain sufficient powers so that the income of the trust is taxable to you, but the ownership of the assets in the trust belongs to your children.

The Internal Revenue Code provides that if you retain the power to borrow from the trust without adequate interest or security, or you retain the right to substitute property of equal value in the trust, the trust is a grantor trust. If your spouse is an income beneficiary of the trust, the trust is also a grantor trust.

How does this help? The answer is two-fold:

First, you will sell all or some of your Class B Non-Voting shares to the trust for either a private annuity or an installment note.

Second, you will be paying the income taxes on the income in the trust even though the assets of the trust belong to your spouse and/or children. In essence, the amount of the tax you pay on income of the trust is a tax-free gift.

Installment Note vs. Private Annuity

Which do you choose?

When selling your Class B Non-Voting shares for an installment note or private annuity, be aware that the concepts and tax consequences for each are different.

The Installment Note

The sale for an installment note is a freezing technique. You have the estate taxes covered for the value of your company now, but don't want to increase the value of your estate. In essence, you want to freeze its value.

Because the sale of your Class B Non-Voting stock is to a grantor trust, the IRS treats the sale as a sale to yourself, and there is no recognizable gain on the sale. The IRS treats the sale as if you took assets from one pocket and put them into another pocket.

Thus, you have no capital gains taxes to pay, and in turn, the payments you receive from the trust on the installment note are without tax consequences.

You die 10 years later. The balance of the installment note is included in your estate, but the appreciation on the shares during the 10-year period escapes any estate taxes.

The Private Annuity

The private annuity will eliminate the value of the stock from your estate on day one. Because a private annuity ends upon your death, it has no value upon your death, so the full value is excluded from your estate.

However, if you live to age 120, your trust will have to continue to pay the annuity for the rest of your life.

Life Insurance

Life insurance can be a very valuable tool if it is purchased by an irrevocable life insurance trust.

If you have an estate plan, and you want to insure the taxes that are payable until your plan has achieved the tax consequences you want, life insurance may be a very good purchase.

Many whole-life policies can generate sufficient cash buildup over a 10- or 12-year period, which permits you to fund the projected estate taxes during the 10- or 12-year period the plan is active. After that period, you cash the policy in for its cash surrender value, which can be equal to all or a large part of your investment in the policy.

A Note on GRATs

If you have done any estate planning and have been told to consider grantor retained annuity trusts (GRATs), we would advise against them in the current low-interest environment. An installment sale to a grantor trust has, in my opinion, more certainty and yields better results.

A Note of Caution

I have discussed the concepts above only briefly. Be aware that there are also exceptions and technical rules that must be followed to ensure a successful outcome.

My advice – Seek competent legal and tax advice before proceeding!

Thanks for reading! Hope this helps!

About the Author

Joel Karp is founder of the law firm Karp & Langerman P.C., which serves as general counsel to closely held businesses, from startups to those doing $200 million in gross sales. You can contact Joel at jkarp@karp-langerman.com. He is based in the firm's Milford, Connecticut, office.