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Death And Taxes vs. Preserving Wealth - The Final Exit Planning Contest

Full disclosure: Wealth preservation planning can't help any of us cheat death, but it can help business owners to avoid taxes and achieve financial security. Read on.

The ideal Exit Plan (one that provides the business exit you desire) includes a strategy to help you preserve your hard-earned wealth from unnecessary taxation when it is transferred to your family. But to preserve wealth, business owners must take steps *before* they actually have it. In other words, to realize all of the potential benefits of various wealth preservation techniques, owners must make plans *before* they convert the value of their businesses to cash.

The foundation for wealth preservation planning is found in the answers to two of the questions you answered in Step One of this Exit Planning process:

1. How much wealth do you want when you exit your company? And, for parents, the follow-up question: How much wealth do you want your children to have?
2. How long before you leave your company?

Using your answers as guideposts, you (and your advisors) can then choose the planning technique that will best preserve your wealth, provide for your family and minimize your tax bill. Let's look at how one fictional owner used wealth preservation techniques to do exactly that.

George recognized that he'd waited too long to begin gifting part of his company to his kids. A week before, George's CPA had told him that, based on the company's pre-tax cash flow of $2 million per year, his company could be worth as much as $12 million to a third party.

After recovering from that shock, George realized first that he didn't need nearly that much cash to retire in style and second, that if he didn't transfer at least half the value of his business before a sale, his family could be looking at millions in gift or estate taxes!

To remedy this situation George and his Exit Planning advisors:

1. Hired a Certified Business Appraiser to assign a conservative, but supportable value to the company.

   Result: Based on current tax case law and valuation principles, the appraiser valued the transfer of a 49% minority (less than controlling) interest at $4 million. In her opinion, the appropriate minority discount was 35 percent of the full fair market value (assumed to be $12 million) of the stock.

   Result: Using the 35 percent discount, George could give away half of the company to his children (a gift valued at approximately $4 million) and would pay no gift tax based on 2011 law which provides for a $5 million lifetime gift tax exemption.

   While George was happy with the idea of not paying tax, he didn't relish using most of his lifetime gift and estate tax exemption, and wanted a better answer. So he took another step to avoid needlessly wasting this most valuable exemption.

2. Created a GRAT—a Grantor Retained Annuity Trust. (See "GRAT Note" at the end of this article for more detailed information.)

   Result: Using a GRAT—perhaps the biggest lever in the Wealth Preservation Game—George would avoid using a significant part of his $5 million lifetime gift tax exclusion, and would still give almost 50 percent of the company to his children.

Through wealth preservation planning performed well in advance of George's exit George was able to:

- Transfer one-half of a business with a fair market value of $9-$12 million to his children in four years (a timeframe George chose) using little or none of his lifetime exemption.
- Receive all of the cash flow from the company during that four-year period, because the annuity payment to George was designed to equal the amount of cash flow expected from the stock transferred into the GRAT. **And George needed this income to achieve his financial security exit objective.**
- Transfer (after four years, or at the termination of the trust) the trust asset (one-half

of the company) to trusts for his children, *completely free of any gift tax*.

George had established these trusts when he created the GRAT to carry out his wishes regarding when, and if, his children would receive money from those trusts.

Techniques such as GRATs and the careful use of minority discounts (as well as many other estate tax avoidance techniques), only work as intended if they are put in place well before you exit your business. These techniques also work well when two objectives, in this case George's financial security and his desire to provide for his family, must be achieved in tandem.

If you wish, we can provide you with additional information about transferring wealth to children and/or protecting as much wealth as legally permissible from unnecessary taxation.

GRAT Note:

We provide here additional details about how and why a GRAT can help to achieve an owner's twin objectives: the need for financial security and to provide for one's family.

A GRAT is an irrevocable trust into which the business owner (and the Trustee of the GRAT) transfers some of his stock. The GRAT must make a fixed payment (annuity) to the owner each year for a pre-determined number of years. At the end of that period, any stock remaining is transferred to the owner's children.

Stock transferred into a GRAT is treated as a gift. The amount of that gift is the value of the asset transferred minus the present value of the annuity that the owner will continue to receive. (George's advisors made sure that the present value of the annuity paid out over four years almost equaled the value of the stock transferred into the GRAT. In doing so, George made only a nominal and non-taxable gift.)

The key to a GRAT's success is to transfer to it an asset that appreciates in value and/or produces income in excess of 120 percent of the federal mid-term interest rate, which fluctuates monthly.

fictitious names and do not represent any particular person or entity.

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