



### **If you want to Transfer the Family Business to the Next Generation...What are you waiting for?**

The combination of today's historically low interest rates and depressed asset values are certain to cause many family business owners heartburn. However, this troubling combination may provide business owners with the opportune time to transfer their family businesses and minimize estate and gift tax consequences. It appears that the federal estate and gift tax system is here to stay. Therefore, business owners should take advantage of today's current economic conditions by planning now.

Basically, family business owners can transfer the family business during their lifetime to the next generation in three ways: either by sale; by gift; or a combination of the two. As most business valuations have dropped due to the current economic crisis, the cost associated with selling or gifting businesses has also decreased. Today's lower valuations can reduce the gift tax exposure or make the potential sale much more affordable for the next generation. In addition, the current interest rate environment is advantageous for any of these transfer planning approaches.

#### **Sale**

Owners looking to sell all or a portion of the family business may consider selling the business outright or using an installment sale arrangement. If only a portion of the business is transferred, the owner may be able to take advantage of potential discounts for valuation purposes. An installment sale occurs when the seller receives at least one payment in a year after the taxable year in which the sale occurred. The seller will have flexibility in structuring the payment terms in order to assist the next generation in purchasing the business. In addition, the installment sale can freeze the value of the business interest transferred for estate tax purposes and allow any future appreciation in the business interest to be passed to the next generation.

In structuring the sale, the buyer would issue the seller a promissory note stating the repayment terms. As long as the promissory note has a stated interest rate that is greater than or equal to the Applicable Federal Rate "AFR", the IRS will not treat the note as a gift. AFRs are published monthly by the IRS, and the rates vary depending on the term of the loan. The current rates for February 2009 range from 0.60% to 2.96%. These rates are generally lower than any rate that the buyer would be able to arrange on their own. In order to assist the buyer, the promissory note could be structured as interest only during the term of the note with a balloon payment at the end. The seller would generally recognize the taxable gain from the sale of the property over a period of years as the note is repaid. The interest portion of each payment would be taxed as ordinary income to the seller and may be deductible for the buyer.

#### **Gift**

A Grantor Retained Annuity Trust (GRAT) is a popular wealth transfer planning technique that can be used by family business owners. The goal of a GRAT is to transfer the appreciation on property that is contributed to a trust with little or no gift tax consequences. A GRAT generally functions best in a low

interest rate environment and by using property that is expected to appreciate during the trust term. A family business that can provide adequate cash flow and has appreciation potential would be a great candidate for a GRAT.

A GRAT is an irrevocable trust in which the grantor transfers assets into the trust and retains the right to receive a fixed payment at least annually for a set number of years. At the end of the trust term, the property remaining in the trust passes to the remainder beneficiaries free of any additional gift tax, even if the property has appreciated significantly. The transfer of property to the trust is a taxable gift, however only the value of the remainder interest is subject to gift tax. The value of the remainder interest is the total value of the property transferred to the trust less the present value of the retained annuity interest discounted using the IRS prescribed Section 7520 rate. The Section 7520 rate, also referred to as the hurdle rate or discount rate, is determined monthly by the IRS and is currently at 2.0% for February 2009. The longer the term of years, the higher the annuity payment amount and the lower the Section 7520 rate, the larger the discount may be when determining the value of the gift. With proper planning, a GRAT can be structured so that there is little or no taxable gift.

GRATs can accomplish an effective estate freeze with little or no tax costs. Over the term of the GRAT, the grantor receives the value of the property transferred to the GRAT in the form of a fixed annuity. In order for the GRAT to be a success, the property in the GRAT must outperform the Section 7520 rate. When interest rates are low, the annuity that must be paid to the grantor is reduced, making it more likely that a significant remainder will pass to the trust beneficiaries. If the trust property is unable to outperform the Section 7520 rate over the term of the trust, the GRAT fails and no value is transferred to the next generation. However, since little or no gift tax was paid on the initial transfer, there is very little down-side risk to using a GRAT. The most significant risk with using this strategy is the grantor's death during the term of the GRAT. If the grantor dies during the GRAT term, some or all of the trust assets will be included in the grantor's estate for estate tax purposes.

Although the current economic crisis is difficult for many business owners, it may be the right time to use the depressed asset valuations and low interest rate environment to their advantage. There are additional planning techniques that business owners may want to consider during this time. Regardless of the strategy, now is the ideal time to contact your advisors for assistance.

*Mark Gaudet, CPA, CFP<sup>®</sup>, is a Principal in the Tax Department of Clark Schaefer Hackett. He can be reached at [mgaudet@cshco.com](mailto:mgaudet@cshco.com).*