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Financialfreedom
WEALTH MANAGEMENT GROUP, LLC

TRANSFERRING WEALTH TO CHILDREN
A PRIMER FOR BUSINESS OWNERS
WHITE PAPER

In their desire to pass wealth to children, business owners are no different than non-business-owning parents. Business owners are different, however, in the tools they can use to transfer wealth.

Whether you own a business or not, the fundamental questions are the same:

1. How much wealth do you want to keep?
2. How much wealth do you want the kids to have? How much is too much?
3. What tools minimize the Estate and Gift Tax consequences of transferring wealth?

Business owners have to put those questions in the context of their exit objective: "How much money do you wish to have after you exit your business?"

Once owners establish their financial exit objective, they can answer the universal questions above and design a transfer mechanism that will pass the wealth to the children with minimal tax impact.

This three-part process is the subject of this White Paper.

1. Fix the owner's financial objectives *before* considering a wealth transfer;
2. Determine the amount of wealth to be transferred (and determine how much is too much); and
3. Design a wealth transfer strategy that keeps the IRS from becoming the largest beneficiary of your hard-earned cash.

To illustrate how one fictional business owner answered these questions, let's look at the case of George Delveccio, a composite of a number of successful business owners.

George opened his meeting with his estate planning attorney with an announcement, "I think I've waited too long to begin gifting part of the company to my son, Chad, who runs the business with me. My CPA just told me that my company could be worth between $12 million and $15 million to a third party because it consistently generates $2.5 million in cash flow annually. I had no idea it could be worth so much!"

"Since I don't need that much, I want to transfer at least half the value of the business—at a lower valuation of course—before any possible sale. I know I can give small chunks of stock to Chad in amounts equal to my annual exclusion and I'm willing to consider using part of my $5 million lifetime gift exemption.

"I want to keep most of my estate tax

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exemption to provide the same level of benefit for my other two children. My wife thinks we should give those two the same amount I want to give Chad—just not using business interest as the gift.

"My CPA told me to meet with you because she thinks there are ways to increase the amount of my gift to Chad without paying gift taxes—especially when combined with gifts to the other two, non-business-active kids. Well? I'm all ears."

George's attorney pointed out that using both his and his wife's annual gift exclusion amounts and his $5 million lifetime gift exemption were sound ideas, but, used alone, would not transfer even half of his total wealth (about $25,000,000) to his children. Even combining George's and his wife's full lifetime gift exemptions, the transfer to the kids would be well less than half of their total wealth.

Compounding the "problem" were two issues: 1) the fact that George had good reason to believe that the company's cash flow would continue to grow, from its current $3 million by at least 25 percent per year for the next three years; and 2) the uncertainty about whether the estate tax exemption would remain at $5 million.

"Given how much more valuable my business will be in a few years, won't it be even more difficult to transfer wealth to the kids? How can I give my kids as much money as possible without paying any more in taxes than absolutely necessary?"

George's prediction of rapid future growth was music to his attorney's ears. "George, the more rapidly your business grows in value...the more cash it spins off...the easier it is to give wealth away and give it away quickly—with little or no gift tax consequences."

As a general rule, we discourage parents from making significant gifts to children until their own financial security is assured. Only after the parents' needs are met do we ask how much is enough—or too much—for the kids.

The attorney suggested that George and his wife answer the first two questions (How much wealth do you want to keep? How much wealth do you want the kids to have?) and that they all meet in a few weeks to explore answers to the third (What tools minimize the Estate and Gift Tax consequences of transferring wealth?)

QUESTION ONE:

How Much Wealth Do You Want When You Leave Your Business?

The primary decision every parent makes when transferring wealth to children is not how to accomplish the transfer, (that's the estate planning attorney's job) but *how much* wealth to transfer to children.

To answer that question, business owners must revisit their financial exit objective; namely, how much wealth you wish to have after you exit your business? The amount of wealth owners wish to leave their children usually (but not always) depends on how much the owners wish to keep after they exit their businesses.

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making significant gifts to children until their own financial security is assured. Only after the parents' needs are met do we ask how much is enough—or too much—for the kids.

The first step in creating a comprehensive Exit Plan is for owners to determine their objectives. Without goals, there can be no plan and owners are rarely able to leave their businesses on their terms.

As a quick review, the three exit objectives that every owner must fix are best phrased as questions:

1. How much longer do I want to work in the business?
2. What is the annual after-tax income I want (in today's dollars) during retirement?
3. Who do I want to transfer the business to?

As George observed, "I want to give the kids enough money to do anything, but not enough to do nothing." That's a noble sentiment, but one difficult to execute—at least without careful planning.

The answer to the second question not only establishes the owner's personal financial goals but also provides the takeoff point for how much money the owner can afford to leave to children.

Most owners draw upon the expertise of their financial and investment planners or exit planning advisors to help answer that question.

QUESTION TWO:

How Much Wealth Do You Want the Kids to Have? (And How Much Is Too Much?)

For many successful business owners, the question of how to leave as much money as possible to children begs the more important question. Given the financial success of the business, the real question is how much money *should* the children receive and *how much is too much*?

As George observed, "I want to give the kids enough money to do anything, but not enough to do nothing." That's a noble sentiment, but one difficult to execute—at least without careful planning. George preferred that his children receive nothing to creating entitled "trust babies."

When owners wrestle with this question of "too much," remember that children need not receive money outright. Rarely are large amounts of wealth transferred to children freely or outright. Instead, access to wealth is restricted through the use of family limited partnerships (or limited liability companies) and the use of trusts. These tools are primarily designed to reflect the parents' desire to restrict their children's (and their spouse's) access to wealth. This is true regardless of the amount of wealth the parent wishes to transfer. Let's look at the steps in a typical "access/control" scenario.

CONTROLLING ACCESS TO WEALTH

Step One. Parents form a limited liability company (LLC) or family limited partnership (FLP) in which the parents own both the operating interest (or general partnership interest) and the limited partnership interests. Limited partners have no ability to compel a distribution, to compel a liquidation of the partnership (or LLC), or to vote. In short, limited partners enjoy few rights and have no control.

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Step Two. Trusts are created for the benefit of each child. The trusts will eventually own the limited partnership interests. A child will be entitled to receive distributions from the trust based on guidelines, parameters and restrictions that the parents prescribe in each trust document.

Restrictions can take several forms. Perhaps the most common limits a child's right to gain access to funds held in the trust. Typically distributions are made over a series of ages, for example one-third of the trust principal at age 30, one-third at age 40, and balance of the trust principal at age 50. The intent is that children be sufficiently mature to handle the assets. Further, if a child mishandles an early distribution, he can learn from his mistakes and presumably will not repeat them with later distributions. At least that's the idea.

Parents can use Generation-Skipping Trusts (or Dynasty Trusts) to allow a child access to trust funds, but without compelling distributions. The biggest benefit to these trust are: 1) the avoidance of estate taxes when the child dies and 2) creditor protection. Creditors (including ex-spouses) may have no ability to access trust assets (depending, of course, upon trust design).

Some parents link distributions to children to the child's achievement of written standards contained in the trust. These standards can include:

- Earned Income. For example, if a child earns $60,000 annually in her employment, she would be entitled to receive an equal amount or some other percentage from the trust.
- Legal Activities. A parent may wish to distribute money to children who engage in (what the parent believes to be) socially useful activities: teacher in a public school, an artist, a writer, an Exit Planning Advisor.
- Illegal Activities. Parents may forbid children from receiving any distributions they would otherwise be entitled to if convicted of a crime or addicted to an illegal substance.
- Existence of a Pre-Marital Agreement. Some parents require a child to enter into a premarital agreement before receiving any distributions from a trust.

Imagination is the only limit on the variety of restrictions parents can place upon a child's right to receive money. Keep in mind, however, that someone—the Trustee—needs to interpret, administer, invest, and make distributions according to the provisions of a trust.

A parent's choice of trustee is at least as important as the trust design. Space constraints prevent a full discussion of desirable trustee characteristics and attributes, but consider the following questions:

- What degree of discretion do you wish to give the Trustee to make distributions to children?
- How long will the trust last?
- What is the value of the trust assets?
- What type of asset is in the trust? If an operating business interest is to be owned by

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the trust, the choice of Trustee may well be different than if the trust is comprised of investment assets.

- Should the Trustee be a family member?
- Who will be entitled to remove the Trustee and for what, if any, reason?

Step Three. After determining the restrictions they want in place, parents transfer the limited partnership interests or non-voting interests into each child's trust. At this point the parent is making a gift of the value of the limited interest to the child.

Unfortunately, parents with large estates often abandon the planning process at this stage because they believe they can only transfer their $10 million combined lifetime gift exemptions to children without incurring immediate tax consequences. As we'll see in a moment, parents are often able to transfer as much wealth to children as they desire.

The toughest question again arises: How much, when, and under what conditions should kids receive the dough?

Planning Can Benefit Charity As Well

Before we leave our discussion of controlling access, there is one additional planning consideration we should mention. Under current estate tax law one spouse can leave assets at his/her death to the other spouse without estate tax consequences. For most estates, taxes are assessed only at the death of the surviving spouse.

If, during their lifetimes, parents are able to give their children (and other heirs) as much wealth as they wish the children to receive, it is then possible to design an estate plan that gives the balance of the wealth at the first parent's death to the surviving parent. When the surviving parent dies, his/her loved ones (yes, your children!) will have received (during that parent's lifetime) all of the wealth the parents wanted them to receive and the balance of the estate can be transferred to charity at the second parent's death. Some families establish private foundations or give money to other charitable organizations with the following result:

- The children receive what the parents want them to receive—during the parents' lifetimes;
- The parents enjoy 100 percent of the wealth remaining as long as either parent survives;
- After both parents die their wealth transfers to a charity of their choice—such as their own private foundation.

And last, but not least,

- The IRS gets nothing. For many parents and business owners this is an estate plan design worthy of close scrutiny. For George Delveccio, a man with strong charitable interests, this was the estate plan design that he chose to implement.

QUESTION THREE:

What Tools Minimize the Estate and Gift Tax Consequences of Transferring Wealth?

The key to transferring large amounts of

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wealth was discussed 2000 years ago by the patron saint of estate planning attorneys, Archimedes. Regarding leverage he observed, "Give me a place to stand and I will move the earth." Using leverage to move the earth—or to move your wealth—is the key to achieving noteworthy results. As we have discussed, each U.S. resident can give away, during lifetime, $5 million as well as the current annual gift exclusion.

George Delveccio's CPA (also a Credentialed Business Appraiser) valued the business at $12 million, a conservative but supportable valuation. The company's stock was recapitalized into voting and non-voting stock. Based on current Tax Court case law, CPA could justify discounting the value of non-voting stock (or a gift of a minority interest of the voting stock). In her opinion, the minority discount was 35 percent of the full fair market value of the stock. Thus, she reduced the "size of the earth" by 35 percent, and was well on her way to leveraging the use of the Delveccio's lifetime exemption amount.

Even with the 35 percent discount, however, a gift of 50 percent of the company (now reduced to approximately $4 million in value) would cause gift tax consequences if George and Eunice also made gifts of equivalent value to each of the other two kids.

Like every other business owner, George was not particularly keen on paying taxes. So he didn't. And he still gave away 50 percent of the company to Chad. He did so by using one of the biggest levers in Archimedes' arsenal—one of the biggest levers in the "Wealth Preservation Transfer Game": a "GRAT"—a Grantor Retained Annuity Trust.

A GRAT is but one of many tools that a lot of clever minds—legal tax and insurance—have created to produce or eliminate estate tax. When these estate planning concepts and tools are combined with lifetime exit planning concepts and tools they work to achieve an owner's lifetime and estate planning objectives.

The keys to success are:

1) Intelligent use of gift and estate tax reduction concepts;

2) Time (because many of these tools work more effectively over time); and

3) Capable and coordinated advisors working in your interest.

A GRAT is but one of many tools that a lot of clever minds—legal tax and insurance—have created to produce or eliminate estate tax. When these estate planning concepts and tools are combined with lifetime exit planning concepts and tools they work to achieve an owner's lifetime and estate planning objectives

How GRATs Work.

After first obtaining a professional valuation of his company George created a GRAT. A GRAT is an irrevocable trust into which the business owner transfers his stock. George transferred all of his non-voting stock--which represented 50 percent of the overall ownership interest in the company.

The GRAT must make a fixed payment (annuity) to George each year for a pre-determined number of years. At the end of this time period,

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which is established when the trust is created (usually two to ten years) any stock remaining in the trust is transferred to the children.

A gift is made when the stock is transferred into the GRAT. The amount of the gift is the value of the asset transferred minus the present value of the annuity that the owner will continue to receive. In George's case, his advisors designed the value of the annuity to be equal to the value of the stock transferred into the trust. Therefore, George only made a small gift of a few thousand dollars when he transferred his stock to the GRAT. To calculate this present value the IRS requires the use of its federal midterm interest rate (currently about two percent). The owner acts as the Trustee (the person in charge of the management of the trust assets, in this case the stock of the company).

Ideally, a GRAT includes an asset that appreciates in value and/or produces income (or grows in value) in excess of the Federal mid-term interest rate. This rate adjusts monthly, but is currently near historic lows.

Most successful businesses, including George's, easily exceed this IRS-mandated threshold. This is especially true when we design the gifting to take advantage of the additional leverage in the form of using a minority discount on the original transfer of the business interest to the GRAT.

Here is where it really gets interesting: George's advisors matched up the amount of the expected "S" distributions payable with respect to the stock transferred into the GRAT (over $1 million per year) with the annual annuity payment (also a bit over $1million per year).

Thus, at the termination of the four-year GRAT, all of the stock originally transferred to it remained in the GRAT (only the "S" distributions with respect to the transferred stock were needed to satisfy the annuity payments). That meant that all of the stock remained and was distributed to Chad tax-free. George paid no gift taxes and his income tax liability during the four-year GRAT period was the same as if he had not made a gift to the GRAT.

Let's summarize what George did:

1. He transferred one-half of a business with a fair market value of between $12 million and $15 million to Chad in four years without using his lifetime exemption.
2. He continued to receive all of the income from the company during that four-year period.
3. At the termination of the trust (four years) the trust assets, (all of the non-voting stock) were transferred to Chad.
4. George incurred minimal gift tax consequences.

Epilogue

The business was eventually sold. George and his wife, Eunice, received far more than they required to maintain their relatively simple lifestyle—even though George had given away one-half of the business without gift tax consequences. George and Eunice subsequently made plans to establish a foundation and give additional wealth during their lifetimes to the

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charities of their choice.

This story illustrates how the effective use of GRATs and a host of other tax-saving and creditor-protection tools, depends on understanding your objectives: for the business and for your family. The goal of all these tools is to ensure your financial security while transferring—without tax consequence and while still alive—the rest of your estate to the persons you choose.

Julia M. Carlson is a Member of the BEI Network of Exit Planning Professionals™

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