Transferring Your Family or Closely Held Business: Part 1

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Transition planning to a family member or other "insider" requires time and forethought to successfully handle both the financial and operational considerations of a family or closely held business. Transitioning ownership and management can be broken down into three key elements: (1) transitioning key management (2) transitioning ownership of the business and (3) creating an action plan.

Transitioning management is a delicate task that requires educating and training management personnel on issues relating to the business transition by identifying appropriate management and key employees of the company and setting forth clear expectations of their individual roles in the transition process.

Transitioning the ownership of a company to a family member or other "insider" should begin with a review of the existing ownership structure of the company. There are a variety of options to effectively transfer company ownership. A practitioner should consider the client's financial needs, both current and future, the client's timeline for transferring ownership, and the potential tax consequences or advantages of the available transfer options.

As with most things in life, proactive planning is critical to the development and successful implementation of a business transition plan. Taking the time to put together an organized and thorough action plan is key to a successful transition. A complete action plan will not only identify management and key employees, but it will specifically define the roles of each of those key players. The action plan should include focused goals and objectives of the company and include a mission statement that is truly reflective of the values of the company and its employees.

One of the most important aspects of putting together an action plan is reviewing the company's corporate hygiene (*i.e.*, reviewing company bylaws, meeting minutes, buy-sell agreements, operating or partnership agreements, employment agreements, etc.). Good corporate hygiene is essential to a successful transfer; if the company paperwork needs work, it should be cleaned up before a transition plan is put into place. The action plan should also incorporate a catastrophe plan, which in light of the past few months should now consider pandemic planning. A well-rounded action plan also sets forth ways to incentivize and retain key employees. Additionally, all lines of credit and loan obligations of the company should be reviewed in order to accurately determine an owner's liability to the company and if that liability needs to be handled prior to or during a transition of ownership.

It is always important to step back and review the reasons for transferring a business to "insiders" (i.e., opportunity for family members, reward loyalty, continue community legacy, continue employment for employees). The "why" can be an important factor in structuring the transition and should guide the choice of technique.

The current depressed market and historically low interest rates create a favorable environment for transitioning businesses to insiders. Gifts to family members make sense now because depressed business values mean smaller gifts. That in turn means less consumption of gift tax credit. In addition, depressed business values may make it simpler to equalize the gift by decreasing the amount of non-business assets needed to pass equal value to other family members.

Installment sales to key employees, other shareholders, or family are popular now because both depressed business values and lower interest rates lower the cost for the insider to purchase the business.

Two more sophisticated options to consider currently include the transfer of the business interest to a Grantor Retained Annuity Trust (GRAT) and the sale of the business interest to an Intentionally Defective Grantor Trust (IDGT).

Using a GRAT as a tool for transition planning begins with an owner (the "Grantor") gifting the business interest to the trust in exchange for an annuity. The retained annuity reduces the size of the gift. The business continues to make distributions to its owners, which now include the GRAT, and the trustee pays the Grantor the annual annuity for the term of years. This strategy removes the business from the Grantor's estate provided the Grantor survives the term. Any growth in the value of the business over the IRS assumed rate (called the Section 7520 rate) will pass to the successor gift tax free. Historically low interest rates mean this hurdle is now fairly easy to beat. For example, the June 2020 rate is 0.6%. Some disadvantages of this strategy include that the Grantor needs to continue to pay tax on income he or she does not receive during the GRAT term and the Grantor must accept that he or she has placed control of the gifted business interest in the hands of the GRAT trustee.

Another sophisticated transfer strategy that works well in the current environment is an IDGT. The name of the trust as "intentionally defective" is misleading: there is nothing wrong with the trust. The trust is deliberately designed to remove transferred assets from the Grantor's estate for estate tax purposes, but to intentionally leave those assets taxed to the Grantor for income tax purposes. The owner (the "Grantor") sells the business interest to the IDGT for fair market value in exchange for a promissory note at an interest rate equal to the IRS Applicable Federal Rate (AFR). Before the transfer, the Grantor gifts "seed" money (usually at least 10% of the planned sale value) to the IDGT. As with the GRAT, proper appraisals of the business are needed and gift tax returns are filed.

Some of the advantages are as follows: the promissory note payments provide an income "safety net" to the Grantor; any growth in the value of the business over the AFR is removed from the Grantor's estate; the Grantor's estate is further decreased by the payment of all income tax (ordinary and capital gain) on the transferred business interest even though the Grantor does not receive the income. If the Grantor dies before the note is fully paid, however, undesired income tax consequences could result. Similar to the GRAT, the Grantor has also placed control of the business interest sold in the hands of the IDGT trustee. IDGTs are particularly effective now because depressed business values lower the purchase price for the buyer. In addition, the historically low AFR (1.01% for long term notes in June 2020) makes it easier to have excess appreciation inure to the benefit of the trust beneficiary.

The silver lining in the COVID-19 pandemic is that a unique combination of depressed business values and historically low interest rates means there has never been a better time to consider transferring your family or closely held business. This content was also featured in a recent Lathrop GPM webinar put on by Sally Stolen Grossman and Bennett Keller; visit the Lathrop GPM website to view a recorded version of Transferring Your Family or Closely Held Business: Two Part Webinar Series. If you are interested in exploring these transfer opportunities, please contact Sally Stolen Grossman; Trusts, Estates & Legacy Planning Practice Group Chair Marya Robben; any member of the Trust Estates & Legacy Planning Group, or your regular Lathrop GPM contact.