

## **ESTATE PLANNING CONSIDERATIONS FOR BUSINESS OWNERS**

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Passing on the business from one generation to the next is often a fundamental concern for the owner of a closely held corporation. By properly positioning the owner's assets and income the estate tax due upon the owner's death can be minimized and the amount of assets passing to the heirs can be maximized. Therefore, some degree of estate planning is appropriate to ensure the orderly transfer of the corporation and the owner's other assets. Certain basic estate and gift tax factors will need to be considered in formulating an estate plan that will provide the business owner with the maximum tax advantage.

### **LONG RANGE GIFT PROGRAM**

One of the most common estate planning strategies for owners of a closely held corporation is gifting stock. Each year, an individual can give away up to \$10,000, tax-free, to each of an unlimited number of persons. Given this gift exclusion for present interest transfers, a long-range gift program can be an effective estate planning tool. If the donor is married both spouses consent to the gift, \$20,000 of stock per donee, per year can be gifted at no transfer tax cost. The gifted stock will no longer be present in the estate of the business owner. Therefore, there will be no stock valuation problems associated with those assets at the time of death.

The advantages to a business owner of an established gift program are that the income that passes to the younger generation may be taxed at a lower marginal rate; the future appreciation on stock will be shifted to the younger generation, thereby reducing estate taxes; over a period of time, control and ownership can be passed to the younger generation without any adverse tax costs; and through transfers, it is possible to avoid the inconvenience of probate and related costs of transferring stock at death. The amount of the gift is the fair market value of the partnership interest or stock at the date of the gift.

### **CORPORATE VALUATION**

The valuation of corporate stock is essential since the IRS can challenge a value utilized for a gift of stock in an estate even though the gift may have taken place many years earlier and even though the gift tax statute of limitations may have appeared to have lapsed. Having knowledge of the value of the corporation is important to the business owner for the following reasons: to evaluate the fairness of an offer to sell, acquire or merge a business, to take full advantage of a strategy of lifetime gifts of stock, and to determine the amounts of deductions for contributions of stock to charity, just to name a few.

There are various valuation methods employed in determining the value of a closely held corporation. One method is to compare the closely held corporation with a comparable publicly held corporation whose stock is traded on the open market to

indicate evidence of the stock's worth. Another is the asset valuation method which is based on a determination of how much the corporation could get for its assets if they were sold incident to a liquidation. A formula approach may also be used to support the valuation of a corporation and includes determining the book value or value of the corporation's net assets and applying the weighted average formula which assigns a weight to the various valuation methods which are averaged to arrive at the fair market value.

Of course, once the market value of the corporation is established discounts must be allowed for other factors affecting the fair market value such as a discount for the lack of marketability, a minority interest discount, or a discount for the loss of a key person. Arriving at the market value can take considerable time and calculation, however, it is an invaluable procedure to the business owner's estate planning.

### REDUCTION OF ESTATE VALUE

Owners of closely held corporations must be concerned about the impact of estate taxes as a lifetime of work represented by the corporation may have to be broken up to pay such taxes. The reduction of the estate value during the owners lifetime can help solve this problem. The Estate Freeze and the private annuity are two of the popular methods of reducing the estate value.

**ESTATE TAX FREEZE:** An estate tax freeze occurs where the taxpayer transfers the appreciation in their corporate stock from their estate to their heirs by "freezing" the value of the estate. Essentially, the taxpayer recapitalizes a closely held corporation so that it will have both voting preferred stock and common stock outstanding. The preferred stock value is set at the current value of the corporation. The stock is retained by the owner of the corporation and the common stock is given to his/her heirs. The common stock has little value as all of the corporation's value is in the preferred stock and there is little or no gift tax owed.

At the owner's death only the preferred stock, which did not participate in the appreciation of the corporate assets, is included in the estate. The recapitalization and gift allows for the future appreciation in value of the corporate assets via the common stock to pass to the owner's heirs without being subject to either gift or inheritance taxes. While at the same time, the voting and dividend rights of the preferred stock give the owner beneficial enjoyment to the entire corporation.

This freezing technique although not new has had some legal changes recently with an emphasis toward valuation of the gift component of the estate freeze. The "special valuation rules" were added to impose stricter rules on valuing the interests retained by the other generation. The purpose of the new rule is to impose a gift tax at the time the "estate freeze" transaction occurs rather than wait until the taxpayer dies.

**PRIVATE ANNUITY:** Another technique for passing on the business at reduced tax cost is the private annuity. A typical private annuity involves the transfer of

closely held stock to a son or daughter in exchange for the child's promise to make periodic payments for the remainder of the shareholder's life. Alternatively, the corporation may redeem the shareholder's stock in exchange for a private annuity. The private annuity reduces or avoids estate tax by removing the closely held business from the estate. At the same time, it offers an opportunity to defer income taxes resulting from the transfer. Further, the annuity payments provide the shareholder/owner with a continuing cash flow and any future appreciation in the value of the business accrues to the person to whom the stock was transferred. Should the shareholder die prematurely, the unpaid portion of the annuity is not an asset in the estate.

Some of the advantages of a private annuity are that when properly structured the private annuity allows for a transfer of closely held stock free of gift tax. From an income tax standpoint, the transfer of stock does not produce an immediate tax. The private annuity can also serve as an additional source of retirement income for the shareholder yielding more favorable tax consequences than consulting fees which may be subject to self-employment tax and challenged as unreasonable compensation or increased dividends.

Some of the disadvantages are that a private annuity may trigger a gift tax in the event that the value of the stock and the present value of the annuity are not equal. Also, the financial burden that is placed on the person obligated to make the annuity payments can be very high especially where the stock value is great and the shareholder's life expectancy is short.

As illustrated, both the corporate freeze and private annuity serve as a means of passing the owner's stock in the business on to the next-in-charge with little or no tax consequences. Look for our article entitled "Liquidating or Selling the Corporation."