Eight Alternatives to Transfer Your Business

The Situation Will Often Dictate Which Option Is Best

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It has been predicted that between 40% and 50% of all privately held businesses will change ownership in the next seven to 10 years. The alternatives in transferring business interests are a common subject of conversation between business owners.

There would seem to be an endless list of alternatives, but this is not the case. The best options are to:

• Transfer the company to a family member;

• Sell the business to one or more key employees;

• Sell to employees using an employee stock-ownership plan (ESOP);

• Sell to one or more co-owners;

• Sell to an outside third party;

• Engage in an initial public offering;

• Retain ownership by becoming a passive owner; or

• Liquidate.

PricewaterhouseCoopers released an analysis early in 2005 which determined the following: about one-half of business owners anticipated a third-party sale, nearly one-fifth anticipated a transfer to the next generation, 14% anticipated a management buyout, 7% expected to sell to an ESOP, and 10% anticipated an IPO or other option.

In determining which alternative is right for you, an extensive fact-finding mission is in order to determine what you wish to accomplish based on the facts. There is no set format for such a plan. In developing the facts and a plan of action, it is best for the business owner to discuss this issue with all his advisors jointly, including a lawyer, certified public accountant, financial/insurance advisor, business appraiser, investment banker, and business advisor.

The team of advisors will need to establish the responsibility of each team member and produce an introductory exit plan. They will also need to valuate the company and determine its marketability, and evaluate the tax consequences of each potential exit path. The fact-finding questions the advisors will be interested in asking the business owner include:

• The nature of the business and its history from inception;

• The general economic condition and outlook of the specific industry;

• The book value of the stock and the financial condition of the business;

• The earning capacity of the company;

• The dividend-paying capacity;

• Whether or not the enterprise has goodwill or other intangible value;

• Prior sales of stock and the size of the block of stock to be valued;

• The market price of stocks of corporations engaged in the same or similar line of business whose stocks are actively traded in a free and open market, either on an exchange or over the counter;

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• Capitalization;

• Diversification of production;

• Labor policies;

• Quality of management;

• Importance of the selling owner to the success of the business;

• Net value of underlying assets;

• Prospects of creating a market for the stock; and

• Restrictions on voting power or the transferability of the stock to be valued.

Since we cannot deal in this article with each alternative in depth, we have selected transfers to family members as the alternative that is the most challenging for the business owner. The most difficult decision concerns which family members are capable of performing the various functions of the business in the future.

This is a very difficult family issue because many times it results in bad feelings. A safe way to make such a decision without family loyalty as an issue is to add new, independent board members to mentor the next generation and to evaluate their performance.

Once a decision is made as to who will be the management team, there are many alternative structures to effectuate a transfer of the business to family members. Let's begin with a fictional case study that will illustrate the various alternatives.

John is the sole owner of the company, which has 200 shares of Class A voting common stock outstanding, and 1,000 shares of Class B non-voting common stock outstanding. John had the business appraised at a fair market value of $12 million.

John's children, Rich and Sue, have worked in the business and are responsible for its growth in the past five years. Rich was named chief executive officer two years ago, and Sue was an experienced marketing executive before joining the company and has been vice president in charge of marketing for the past two years.

John would like to retain one-tenth of the shares in the company. To accomplish John's transfer goals, John will need to transfer 90 shares of Class A stock and 486 shares of Class B Stock to both Rich and Sue. John has several alternatives for making these transfers. First, he could make a direct gift of the stock. Second, he could make a sale to an intentional defective grantor trust (IDGT). Third, he could transfer the shares to a grantor-retained annuity trust (GRAT). Fourth, he could sell the shares to Rich and Sue as a conventional sale would be made to a third party.

Under any of the alternatives, the shares will be discounted as allowed by IRS Revenue Ruling 93-12. We will assume for the examples a minority interest discount of 20% ($2.4 million) and a further non-marketability discount of 20% ($1.92 million) for a total company value of $7.68 million. Thus, the discounted value of the 90% of the company to be transferred is $6,912,000.

Here's how the various scenarios could play out:

Direct Gift. Under the gift-tax laws in effect for 2011 and 2012, John and his wife, Ruth, can each make direct gifts of $5 million without paying any gift tax. Ruth will elect to share in John's gift. With the total gift being $6.912 million, John and Ruth will each report a $3,456,000 gift, leaving each with a remaining exemption of $1,544,000. However, note that there will be no step-up in basis at John's death as would have occurred had John owned the shares at his death. Provided John survives three years from the date of the gift, there will be no Massachusetts estate tax on the gift.

Intentionally Defective Grantor Trust. An IDGT is a trust that is 'defective' solely for income-tax purposes. The fact that the grantor-trust rules are different for income tax and for gift and estate tax creates planning opportunities. For estate and generation-skipping tax (GST) purposes, transfers to IDGTs will be completed gifts and outside the estate. However, for income-tax purposes, the existence of the trust is ignored, and the grantor is treated as the owner of the trust.

John's stock can be sold to an IDGT free of income and capital-gains tax. Provided it is sold for a note of equal value, there will be no gift tax. John will sell 90% of his stock to the trust in exchange for promissory notes for a fixed term of years. The notes will pay enough interest to classify the trust as above market value, but the underlying assets are expected to appreciate at a faster rate. All future income (not including the interest paid on the note) that the stock generates from the company will be taxed to John. The tax John pays on future income in the IDGT further reduces his estate. The stock in the IDGT therefore appreciates tax-free, outside John's estate.

The IDGT needs to be seeded by a cash gift, a gift of company stock, or both. The seed should be approximately 10% of the total value transferred, in this case approximately $768,000 if a cash gift and $691,200 if a gift of shares. The distributions from the company will be used by the trust to make payments on the promissory notes. With a gift of cash, the promissory notes will be in the amount of $7,680,000 in the aggregate, and with a gift of shares in the amount of $6,220,800 in the aggregate. The notes can provide for interest payments only to maximize value inside the IDGT, and can allow for prepayment without penalty. The interest rate is based on IRC Section 1294(a). The interest rates for March for a note payable annually in nine years are 2.44% and 4.30% in excess of nine years.

Grantor-retained Annuity Trust. A GRAT is a trust with a specific life or term, such as 5 years, 8 years, etc. The grantor transfers assets to the GRAT and retains an interest in the trust. This income interest will be stated as an annuity percentage of the original assets transferred to the GRAT. Each year the GRAT will pay the grantor the required annuity payment.

To establish the GRAT, John will transfer 90 Class A shares and 486 Class B shares to the two individual trusts established for Rich and Sue. The income beneficiary for a term certain will be John. Rich and Sue will each be the owner of the assets of one trust at the end of the term certain. If John survives the trust term, the transferred shares are no longer included in John's estate.

If John, at 65 years of age, transferred his shares to a GRAT in February 2011 with annuity payments for 10 years, there would have been a gift of $457,762 and annual payments on the annuities of $1,036,800.

There are some negatives to using a GRAT. Under Internal Revenue Code Section 2642(f)(1), the grantor of a trust cannot effectively allocate GST tax exemption to property transferred until the close of the estate-tax inclusion period. Thus, it appears that, in order for GRAT property passing to the GRAT remaindermen to be exempt from GST tax, the grantor must allocate GST exemption to the remainder property at the end of the GRAT term rather than at the time the property is initially transferred to the GRAT.

Conventional Sale to a Third Party. A conventional sale of the shares to Rich and Sue could be done on the same basis as a GRAT, i.e. in exchange for a term note. However, John would have to pay capital-gains tax on all of the principal payments received. John would also have to pay ordinary income tax on the interest. In addition, unlike an IDGT, John would not be able to pay the taxes on the earned income of the corporation. And if John dies before the note is paid off, the value of the note will be included in his estate. As a result, a conventional sale would be the least tax-efficient of the alternatives.

The choice of which alternative is right for John, or for any business owner, is very personal. It will depend not only on the business itself, but also on John's objectives: his and his spouse's financial objectives and needs on John's retirement or death, estate equalization for other family members, the needs of the next generation, and charitable objectives. As you can see from the differences in the alternatives set forth, the fact-finding process is essential to making this decision. ■

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