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ORANGE COUNTY BUSINESS JOURNAL

AUGUST 5, 2002

Reducing Taxes on Your Business While Passing Assets to Your Heirs

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A majority of closely held businesses will fail to pass from one generation to the next. The major culprit causing such failure is the estate tax. On larger estates the estate tax will consume approximately 50% of the estate, and the estate tax is due within 9 months of date of death. However, since October 1990, under the Chapter 14 rules of the Internal Revenue Code, Congress has made the estate tax optional, if there is proper pre-planning of the estate.

Perhaps the most effective tool to accomplish the elimination or reduction of estate taxes for business owners is known as the "SuperGRAT". The SuperGRAT is a two step estate planning device that combines the existing business structure with different trusts to achieve various business and tax planning goals.

Start with the current corporation. The first step involves a simple recapitalization of the existing corporation to provide voting and non-voting shares. The SuperGRAT approach allows owners to retain all of the voting shares so that they keep total control over the business during their lifetimes.

Step two is performed by transferring the non-voting shares into irrevocable trusts. These trusts are designed to give the business owner the right to the income from the business for a fixed term of years. This term of years varies from person to person, depending upon each individual's age, health, and other factors.

After this fixed term expires, owners may choose to reacquire these non-voting shares if they wish to continue receiving the income from the business. Otherwise, the non-voting shares will pass in trust to the owners' specified beneficiaries, known as the "remainder beneficiaries" of the trusts.

The advantages with the SuperGRAT approach are many. In addition to allowing the owners to maintain control over the business and keep the right to the income from the assets, the SuperGRAT plan effectively allows owners to pass the future appreciation on the business out of their estate and on to their beneficiaries. At the same time, they will substantially compress the value of the business for current gift tax purposes. The result is a reduction in total tax paid, which passes more of the business to future generations and allows future generations to keep the business, rather than forcing a quick sale in order to pay estate tax.

For example, assume Mr. and Mrs. Jones, husband and wife, both age 65, together own a business currently valued at $10 million which generates a net cash flow of $900,000 annually. Under the SuperGRAT method, this business is recapitalized into 1% voting shares and 99% non-voting shares. Note, however, that if the business interest is not currently incorporated, alternative entities may be utilized instead, such as a Limited Liability Company. Mr. Jones then transfers his 49.5% non-voting shares into an irrevocable trust which will pay him income of just under $450,000 per year for the next thirteen years. However, this income payment is just the minimum, and the trust is also allowed to pay income in excess of this amount to Mr. Jones. Likewise, Mrs. Jones will transfer her 49.5% non-voting shares into a separate irrevocable trust which will pay her income of just under $450,000 per year for the next ten years.

By putting these non-voting shares in trust irrevocably, Mr. and Mrs. Jones have each made a gift of their interests to the remainder beneficiaries. However, the value of this transfer for gift tax purposes is not 99% of the value of the business, or $9,900,000, but merely $983,860 as calculated under tax tables and guidance provided by the IRS.

This accomplishes a valuation compression in the ratio of nearly 10 to 1, meaning that the SuperGRAT will allow Mr. and Mrs. Jones to transfer $10 worth of assets from their taxable estate at a tax value of only $1! This amount can be offset by a portion of each spouse's $1,000,000 applicable exclusion amount (formerly unified credit amount), which is the maximum amount of assets each person can pass to their heirs free of estate tax. Thus, no gift tax due! Additionally, all future appreciation of the business will pass estate-tax and gift-tax free to the beneficiaries specified by Mr. and Mrs. Jones.

In summary, the SuperGRAT is a powerful estate planning tool that allows the business owner to remove from the owner's estate for tax purposes the current value and future appreciation of the business interests at a substantially reduced gift tax value, while retaining control and the right to receive the income from the business. It also provides flexibility for future planning and the advantage of providing creditor protection for the business owner's beneficiaries.

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