

Leveraging Tools to Minimize Estate and Gift Tax Consequences

The key to transferring large amounts of 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 \$1 million during a lifetime, as well as \$12,000 annually.

In the case of George Delveccio, the fictional business owner we've used as a case study in the last few issues, his CPA (also a Certified Valuation Analyst) valued his air freight expediter business at \$9 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, the CPA could justify discounting the value of non-voting stock (or a gift of a minority interest of the voting stock). In the CPA's opinion, the minority discount was 35 percent of the full fair market value of the stock. Thus, the CPA reduced the size of the "earth" by 35 percent, and Archimedes was well on his way to leveraging the use of Delveccio's lifetime exemption amount.

Even with the 35 percent discount, however, a gift of 50 percent of the company (now reduced to approximately \$3 million in value) would exhaust George's and his wife, Eunice's, combined lifetime gift exemption amounts of \$1 million each, as well as cause the payment of a gift tax of approximately \$400,000.

Like every other business owner, George was not particularly keen on paying a tax of \$400,000. So he didn't. And he still gave away 50 percent of the company to his children. He did so by using the biggest lever in the "Wealth Preservation Transfer Game:" a "GRAT"— Grantor Retained Annuity Trust.

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 or her stock. George transferred all of his non-



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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 predetermined number of years. At the end of this time period, 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, which the owner will continue to receive. To calculate this present value, the IRS requires the use of its federal mid-term interest rate (currently about six percent). The owner can act as the Trustee (the person in charge of the management of the trust assets, in this case the stock of the company).

Using George as an example, he transfers his non-voting stock, valued at \$3 million, into his GRAT. The amount of the gift is determined when the GRAT is funded. George's GRAT was funded with \$3 million of stock and required a \$1 million annual payment for four years. Recall that the \$1 million distribution amount is the amount of dividend distribution the company normally made with respect to one-half of the stock. Consequently, all of the stock originally transferred to the GRAT will still be there after four years.

The IRS, however, must assume that a \$3 million asset will produce only \$180,000 of distributions/growth a year. (It bases that assumption on its current six percent Federal mid-term interest rate.) Consequently, to design the GRAT to generate an annuity payment of \$1 million per year means that the GRAT theoretically distributes—using the IRS's interest assumptions—roughly \$820,000 of the GRAT's principal (the non-voting stock) in the first year of the GRAT. In each of the ensuing three years, even more principal will be distributed to satisfy the annual annuity payment until (theoretically) the principal of the GRAT is exhausted. As you can see, if the IRS's six percent assumption is correct, all of the GRAT assets must be distributed to satisfy the annual \$1 million annuity payment. Of course, if George's company maintains its capacity to pay its regular distribution of \$1 million with respect to 50 percent of the stock, all of the stock will remain in the GRAT after the four-year GRAT term.

For gifting purposes, however, George is entitled to use the IRS's interest assumption. This results in nothing being left in the GRAT, and therefore no gift was made at the time the GRAT was created. In George's situation, when the GRAT terminates four years hence, the remaining stock (in this case ALL) is transferred to the children without further gift consequences. The children receive one-half of the company at no gift tax cost.

The key to making a GRAT work well is to have an asset that appreciates in value and/or produces income (or grows in value) in excess of the Federal mid-term interest rate. Many successful businesses 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.

Let's summarize what George did:

1. He transferred one-half of a business with a fair market value of \$9 million to his children 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 asset, consisting of non-voting stock, was transferred to trusts for George's children. These trusts were in turn established by George when the GRAT was created and contained his wishes regarding when, and if, the children were to receive money from those trusts.

As illustrated in the example above, GRATs can be an effective tool for effectively transferring wealth to children with reduced tax impact. If you have any questions about transferring wealth to children, please contact us to discuss your particular situation.

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