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Benefits of Using Trusts with Selling Your Business

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SELECT PORTFOLIO MANAGEMENT, INC.
Integrated Wealth Management
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Using Trusts

What is using trusts to gift your business?

Using trusts to gift your business is a technique whereby, rather than gift your business directly to your beneficiaries, you transfer ownership of your business to a trust and then name your children, grandchildren, or others as the beneficiaries of the trust. The entire business may be transferred to a trust in one transaction, or the stock may be gifted to the trust over a period of time. The trust can be set up as either a revocable trust or an irrevocable trust.

You may realize significant estate and income tax savings if you transfer your business interests to a trust. You may also want to transfer your business to a trust if your children, grandchildren, or other beneficiaries are minors or incapable of managing assets responsibly.

Why use a trust to gift your business?

Use a trust if children are minors

Rather than directly gift stock in your business to your children, you may want to gift the stock into a trust (either a revocable or irrevocable trust) if your children are minors or are irresponsible with money. In other words, you may not want your children to directly own the stock in your business until they reach a certain age.

> **Example(s):** You are the sole owner of all the shares of your closely held business. You have three minor children. You would like to begin to gift shares of the business to your children, but you do not want to transfer the shares directly to them until they become older. One solution would be to set up a trust, name your three children as the beneficiaries of the trust, and then gift the shares to the trust. A trustee could be appointed to oversee and manage the stock in the trust for the benefit of your three minor children.

May result in significant estate tax savings

If you set up a trust as an irrevocable trust and then transfer shares of your business to the trust, there may be significant estate tax savings. If the trust is irrevocable, any shares that you transfer to the trust will not be included in your estate for estate tax purposes. Furthermore, any appreciation in the value of the shares after the transfer into the trust will not be included in your taxable estate.

> **Example(s):** You set up an irrevocable trust, name your two children as beneficiaries, and begin a program of transferring shares of your closely held business into the trust. At the time of your death, you have transferred 40 percent of the shares into the trust. The value of the shares in the irrevocable trust, including any appreciation in the stock after the transfer to the trust, will not be included in your estate.

> **Caution:** You may have to pay gift taxes at the time of the transfer to the trust. However, the gift may qualify for the annual gift tax exclusion, and/or you may be able to discount the value of the gift for federal gift tax purposes. You may also be able to use your gift tax applicable exclusion amount (formerly known as the unified credit) to cover federal gift taxes due.

Gift of shares into an irrevocable trust may qualify for annual gift tax exclusion

When you transfer shares of your closely held company to an irrevocable trust, the gift may qualify for the annual exclusion from the federal gift tax. The annual exclusion means that you can make gifts of up to $12,000 per donee without paying any federal gift tax. A married couple can split the gift and give an amount equal to double the annual exclusion per donee, as long as both spouses are U.S. citizens and they make the gift jointly. However, to qualify for the annual exclusion, a donee must have a present interest in the gift (i.e., have the immediate right to use, possess, and enjoy the gifted property). This requirement can be a problem for certain trusts where the beneficiaries do not have a present interest in the gifted stock. There are ways (i.e., giving the beneficiaries Crummey powers) to give the beneficiaries a present interest in the assets transferred to the trust. If the gift of stock does qualify for the annual exclusion, you may be able to transfer a substantial amount of stock to the trust over a number of years and not pay federal gift taxes (although you may still owe state gift tax).

> **Example(s):** You set up an irrevocable trust and name your three minor children as the beneficiaries of the trust. You give your children Crummey powers in the trust, whereby each child will have the right to withdraw any contributions to the trust within a certain period of time (usually 30 to 60 days). Your children are thus considered to have a present interest in the assets gifted to the trust, and the transfer will qualify for the annual exclusion. For example, you and your spouse could gift $24,000 worth of stock to the trust per beneficiary (for a total of $72,000) and not pay any federal gift tax. This stock would also not be included in your estate when you die. Over a period of time, you could transfer a substantial amount of stock in your company to the trust for the benefit of your children and not pay any federal transfer taxes.

Gift of closely held stock into certain types of trusts may be discounted

If you transfer your stock in your closely held company to a grantor retained trust, you may be able to discount the value of the transfer for federal gift tax purposes. A grantor retained trust can be set up as a grantor retained annuity trust (GRAT), a grantor retained unitrust (GRUT), or a grantor retained income trust (GRIT). With any one of these three trusts, you transfer assets to the trust and then retain either an income interest or a use interest for a period of time. The Internal Revenue Service (IRS) allows you to discount the value of the initial gift based on the length of the retained interest and the applicable federal interest rate.

> **Example(s):** You set up a grantor retained annuity trust and transfer $300,000 of your closely held stock to the trust. You name your three children as the beneficiaries of the trust. You retain an income interest for a period of 10 years, during which you will receive $15,000 per year in income from the trust. Based on the length of the retained interest and on the applicable federal interest rate, the gift is valued at $150,000, and you must pay the applicable gift tax on this amount. However, you can use your gift tax applicable exclusion amount, if available, to cover any tax that may be due. Furthermore, if you outlive the term of the retained interest, then the value of the stock in the trust will not be included in your estate for estate tax purposes. If the stock were worth $600,000 when you died 20 years later, this entire amount would not be included in your estate. (However, if you die before the retained term ends, the full value of the assets in the trust will be included in your estate.)

Stock in trust does not have to be probated

Another reason to transfer your closely held stock in your business to a trust (either a revocable or irrevocable trust) is that the assets in a trust do not have to go through probate. Probate is a public process, so anyone can go down to probate court and view the contents of your will. This may be of concern to you if you do not want anyone to know how many shares you own, the value of those shares, and to whom they will be transferred. However, a trust is a private document. Once you transfer shares to a trust, only you and the trustee need to know the contents and the terms of that trust. Furthermore, shares may be transferred to the beneficiaries more quickly and easily through a trust than through your will. With a trust, upon your death the shares can be transferred immediately to the beneficiaries in accordance with the terms of the trust. A will, in contrast, must be probated before the assets can be distributed. This procedure may take six months to two years to complete.

Trust may give protection against creditors

When you transfer your closely held stock to an irrevocable trust, you may protect that stock against the claims of future creditors. Typically, there is a time period (called the statute of frauds) after which your creditors cannot attach and seize assets that have been transferred to an irrevocable trust.

> **Example(s):** You set up an irrevocable trust and name your two children as the beneficiaries of the trust. You transfer $200,000 of your closely held stock to the trust. Five years later, you are sued, and a judgment for $700,000 is obtained against you. In most cases, your judgment creditor cannot attach and seize the stock that you had previously transferred to the trust.

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