Tax/Estate Planning

Pre-transaction estate planning can mean recipients get more

ESTATE PLANNING

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Over the course of the past few years, Houston has experienced a significant increase in sales and mergers of businesses. While much is discussed about what these transactions mean to the Houston economy, behind each sale are one or more key shareholders who are about to receive significant value for their years of hard work and risk.

In many cases, these individuals — whether they are a key group of closely held business owners about to sell to a larger company or are executives of a thinly traded public company whose stock is about to be sold in a merger with significant liquidity and premium realization — begin to think about how they would like to share the proceeds with their children or charity. Unfortunately, by the time many of these shareholders actually seek advice on how to do this on a tax-efficient basis, it is too late to take advantage of many of the most attractive planning opportunities.

DETERMINING THE VALUE

Generally speaking, an interest in a non-publicly traded business has a very speculative value. When a transaction is contemplated, appraisers are usually hired to value the interest being transferred to family members. They first value the company, and they then apply discounts for lack of control, lack of marketability and other appropriate factors.

In many cases, these considerations on a combined basis represent a discount of up to 50 percent from the entity's value, and the entity's value is frequently already assessed at less than what the owners would like to sell for in the future.

As a result, a transfer of partial ownership in a company at such discounts can, when later followed by a sale of the company at a much higher price, transfer significant wealth to younger generations without a gift tax.

For example, if a shareholder gives to his children 20 percent of a company which is appraised at $20 million, and the discounts total 40 percent, the gift is valued at only $3 million. But if the company is sold a year later for $30 million, the children receive $6 million. In essence, one half of that wealth was transferred free of gift tax.

BEFORE THE SALE

Needless to say, results such as these cannot be reproduced after the sale. And while discounts are still available after the company has retained investment bankers, or has a letter agreement in place and is negotiating the sales agreement, they are not as significant and the benefit of the transaction is diluted.

As a result, those in a position to pass on interest in a business should consider:

Gifts or sales of closely held business interests to family members can usually take place without diminishing the ability of the shareholders to control the company and receive compensation. As a result, shifting ownership of a portion of the company at an early date can produce dramatic results with little cost or inconvenience to the original owners, even if a sale is not currently contemplated.

As an alternative, an estate planning transaction should at least take place as soon as possible before the contemplated sale, usually before the business retains its sales consultants or investment bankers (since this fact would normally have to be disclosed to the appraisers). Ideally, most estate planners would like to see a gift or sale to family members take place at least in the calendar year before the likely sale.

SHIFTING WEALTH

There are many techniques which can be used to shift value to children or other family members. Among them are gifts, installment sales and grantor retained annuity trusts. Different techniques will fit different business and family situations.

Trusts and partnerships can be used to help address concerns about younger generations receiving "too much, too soon" if a transfer ends up being successful.

If a business is already sold and the opportunity to shift wealth was not taken, then all is not lost. When the owner makes his next investment in an entrepreneurial business, the owner can use that as an opportunity to place children or trusts in that business at inception, so that any future growth is out of the parents' estates.

If charitable gifting is a goal, the considerations are somewhat different. Gifts, when the stock is valued low, produce little or no charitable deduction. And many

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company owners would have concerns when a charity holds an interest in their closely held business.

Wonder if it doesn't sell? This is particularly a problem when the intended charity is the owner's own private foundation, which is subject to very strict self-dealing prohibitions.

For these reasons, most business owners will want to wait until shortly before the sale itself before gifting to charity. But they cannot wait until the very last minute, or the Internal Revenue Service will treat it as a "deemed sale" by the owner followed by a transfer of the proceeds to the charity.

Furthermore, when a sale is for cash, the owner's tax advisers need to calculate whether it is actually better to make a cash contribution after the sale. This does not avoid capital gain, but maintains the owner's control throughout the transaction and gets a bigger deduction.

On the other hand, a gift before the sale has a smaller deduction but avoids capital gain completely.

The best charitable alternative, of course, is when the company is not sold for cash, but for publicly traded stock in a tax-deferred structure. In that case, the owner can wait until after the closing and then gift the publicly traded stock. This allows the owner to both avoid capital gain and get a larger tax deduction. ■

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