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Craig Smalley • Aug. 30, 2017

Most business owners want the same thing; they want to pass on their business to their kids. Others may want to sell the business, and some just want to give it away. However, all these options have unique tax concerns that must be considered. In this article, we are going to focus mainly on the removal of an S-Corporation from an estate.

Before we start talking about the different ways to pass along your S-Corporation to

passing the business along while you are still alive and wanting to maintain control of the business.

Probably the most common way to pass along the family business is through either a Grantor Retained Annuity Trust (GRAT), or a Grantor Retained Unitrust (GRUT). Here is how a GRAT works. Let's say that a company is worth $1 million today. The owner of the S-Corporation sells his stock to the GRAT for $1 million. During the life of the GRAT, the shareholder retains control over the S-Corporation and the value of the company freezes at $1 million. A GRAT is good for ten years and the current income of the S-Corporation is used to pay the grantor $100,000 a year for ten years. The trust is irrevocable and is the owner of the shares of stock. The beneficiaries of the GRAT are the owner's children. After the GRAT is completed, the thought is the value of the S-Corporation will go up. When the trust terminates after its ten-year term, then the beneficiaries inherit the stock of the S-Corporation.

Since the Estate Tax threshold is $5.49 million and almost $11 million if portability is selected, what I am about to say will rarely come into play. However, the point of the GRAT is to freeze the assets' value and to remove it from the owner's taxable estate. Should the owner die while the GRAT is still in effect, then the GRAT is dissolved with the current value of the S-Corporation stock is reverted back to the owner's taxable estate.

On the other hand, a Grantor Retained Unitrust (GRUT) is a form of irrevocable non-charitable trust. During its term, the trust makes payments to the donor of the trust (the grantor) that are equal to a fixed percentage of the trust's value, as determined on a specified day of the year. When the trust terminates, its remaining principal passes to remainder beneficiaries named by the grantor, typically children or grandchildren.

The grantor of a GRUT makes a taxable gift to the remainder beneficiaries. The

process of selling the business to his children. My advice to him was to split his shares into voting and non-voting shares. He was an S-Corporation, but voting and non-voting shares do not constitute a separate class of stock. He then formed an IDGT and transferred 99% of the non-voting shares to the trust, holding onto 1% of all of the voting shares. This way, he didn't lose control.

What makes an IDGT defective is that it is an estate planning tool used to freeze certain assets of an individual for estate tax purposes, but not for income tax purposes. The intentionally defective trust is created as a grantor trust with a purposeful flaw that ensures that the individual continues to pay income taxes, as income tax laws will not recognize that assets have been transferred away from the individual. Remember: only grantor trusts can own S-Corporation stock and an IDGT doesn't do anything to upset that.

My client's business was worth $4 million. He wanted to retire fully at age 65. He sold his stock to the trust for $4 million as an installment sale. The kids didn't actually pay that much for the stock, they used the current income from the company to pay their parents for the business. They paid their parents $266,000 a year. Because the parents worked less than 500 hours every year, they were treated as passive owners. Not only did they receive $266,000 per year, they also shared in the profits of the business, to the tune of about an additional $100,000 per year, which was mostly tax free.

The fact of the matter is that most parents want to simply give their businesses to their children, but they can't. The gift of stock would require a gift tax return to be filed and the value of the stock would be subtracted from the parent's uniform tax credit, which could require them to pay Estate Tax upon death.

A word about trusts, don't be afraid of irrevocable trusts. As we all know, irrevocable trusts can't be changed. However, before they are executed, the grantor can put restrictions in place to help safeguard the assets while maximizing the benefits to the

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