CPA Practice Advisor

Sep. 21, 2017

Estate Planning Part I – Passing Along Your Business to Your Children

By Craig W. Smalley, MST, EA

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 your children, I want to let you know that there is no right or wrong way to do this. Some people want to sell their business to their children while others would rather give it away. There is no one way to do this.

[This is part one of a three-part series on estate taxation strategies. Click to read

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 amount of this taxable gift is computed when the trust is funded and equals the funding amount minus the present value of the payments that the trust will make to the grantor. There is no transfer tax assessed at the time the trust terminates and distributes its remainder to its ultimate beneficiaries. Consequently, a GRUT can be an effective method for transferring assets to heirs at a reduced transfer tax cost.

Something that I came up with for a client was using an Intentionally Defective

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 beneficiaries.

———

Top Tax Social Media:

Future Blog. http://bit.ly/2f1nrHN

Tax Policy in the Trump Administration. The TaxProf Blog. http://bit.ly/2f0L4Qm

———-

Latest Tax News:

IRS Gives Tax Relief to Texans Affected by Hurricane Harvey. Includes an additional filing extension for taxpayers with valid extensions that run out on Oct. 16, and businesses with extensions that run out on Sept. 15. www.cpapracticeadvisor.com/12363478

How to Protect Tax Clients from Cyber Threats. All tax practitioners, from the largest of firms to the smallest of offices, have a legal obligation to protect taxpayer information in their care. www.cpapracticeadvisor.com/12364109

IRS Should Change Proposed Partnership Audit Regs, Says AICPA. Organization has urged the IRS to make changes to its proposed regulations that are intended to implement the new Centralized Partnership Audit Regime. www.cpapracticeadvisor.com/12359791

Ransomware Scammers Posing as IRS and FBI Agents. The scam email uses the emblems of both the IRS and the Federal Bureau of Investigation and entices users to select a "here" link to download a fake FBI questionnaire. www.cpapracticeadvisor.com/12363481

Tax Court Says Handyman Can't Claim These Deductions. The Tax Court concluded that the taxpayer received gross income in 2012 equal to the value of the services that he provided to the trust. www.cpapracticeadvisor.com/12363177