

# Three Wealth Transfer Strategies Every Business Owner Needs To Know

**The Great Wealth Transfer: Strategies for Succession, Legacy and Wealth Generation**

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It is estimated that $1.5 to $2 trillion is passed annually to younger generations. As the "Great Wealth Transfer" continues, family business owners face a distinct set of personal and sometimes conflicting wealth transfer considerations. These include preserving control, minimizing estate taxes and transaction costs and equitably transitioning ownership across generations. A well-designed estate plan, incorporating both testamentary planning and *inter vivos* transactions, can accomplish these objectives. This advisory summarizes three strategies that enable a family business owner to transfer future upside to the next generation (G2) while reducing transfer taxes: recapitalizations and discounted sales, sales and gifts to intentionally defective grantor trusts and grantor retained annuity trusts.

This is the fifth and final part in a series examining the impact of the "Great Wealth Transfer" on business and succession planning for family business owners. For more, click here to receive our extensive guide, *The Great Wealth Transfer: Strategies for Succession, Legacy and Wealth Generation*, coming later this year. The guide will expand on the topics covered in the series and provide additional context, explanations and cost-benefit analyses for each topic.

## Why Timing Matters

The most powerful wealth transfer results arise when planning occurs well in advance of a liquidity event. The goal is to use a lower, but appropriate and reasonable, valuation for the estate planning transaction than the anticipated liquidity event will produce. This reduces transfer taxes and shifts more wealth outside the business owner's taxable estate. However, if the estate planning transaction and the liquidity event take place too close together, the Internal Revenue Service (IRS) can argue that the valuations should be equal. These adverse effects can generally be avoided if sufficient time is given between the estate planning transaction and the liquidity event.

### 1. Recapitalization and Discounted Sales of the Family Business

Many family businesses begin with a single class of equity interests. A frequent first wealth transfer maneuver is a tax-free recapitalization into voting and non-voting equity interests. Following the recapitalization, family business owners typically sell or gift the non-voting equity to family trusts for the G2 at values reflecting applicable discounts for lack of control and lack of marketability. Best practice is to obtain an appraisal that satisfies Treasury Regulation § 301.6501(c)-1(f)(3), which sophisticated legal counsel can help ensure. This allows the business owner (i.e. the senior generations) to retain the voting interests and therefore control of the business while passing the economics of the business to the G2 on attractive terms.

It is important that the substance of the transaction be respected. For example, if a trust purchases non-voting equity in exchange for a promissory note, the trust should make all required payments in a timely manner. The promissory note should bear a reasonable rate of interest and be secured by the transferred equity. Simply put, the transaction should resemble any similar arm's length transaction. If the substance is not respected, the IRS may argue that the transaction was a disguised gift. When executed with due care, recapitalizations and discounted sales can shift substantial future appreciation out of the business owner's estate while preserving control and operating flexibility.

### 2. Sales and Gifts to Intentionally Defective Grantor Trusts

An intentionally defective grantor trust (IDGT) is an estate planning vehicle that is "defective" for income tax purposes, meaning the grantor (i.e. the person who establishes the IDGT) is treated as the "owner" of the trust for income tax purposes, while the assets contributed or sold to the IDGT remain outside the grantor's estate for estate tax purposes. This dichotomy creates planning opportunities because the grantor's payment of the IDGT's income taxes is effectively an additional tax-free transfer to the IDGT's beneficiaries.

Similar to above, the first step involves the business owner recapitalizing the business into voting and non-voting equity interests. The grantor then funds the IDGT with a seed gift to provide economic substance and support the IDGT's ability to service its debt obligations. The grantor then sells all or a portion of the remaining non-voting equity interests in the family business to the IDGT in exchange for a promissory note consistent with best practices noted earlier.

Because the grantor and the IDGT are treated as a single taxpayer for federal income tax purposes, the sale is disregarded for income tax purposes. Over time, cash flows from the family business repay the promissory note, and additional cash flows accrue to the IDGT's beneficiaries outside the selling business owner's estate. The beneficiaries capture the upside of the family business's growth without paying income taxes, because such taxes remain the responsibility of the grantor.

### 3. Grantor Retained Annuity Trusts

Separate and distinct from the prior strategies, a grantor retained annuity trust (GRAT) is a statutory wealth transfer technique that allows the grantor to contribute assets to the GRAT for a predetermined duration (as little as two years) in exchange for a fixed annuity. Any cash flow from, or appreciation of, the contributed assets above a statutory hurdle rate passes tax-free to the GRAT's remainder beneficiaries. If optimally structured, a well-designed GRAT strategy allows a family business owner to make tax-free transfers to the beneficiaries.

GRATs can be especially effective for assets expected to appreciate significantly or that exhibit substantial volatility. They are also attractive where valuation uncertainty is present because of certain protections under the Treasury Regulations. However, the principal downsides are (1) GRATs are not effective dynastic planning vehicles and may not lower generation-skipping transfer (GST) tax exposure; (2) if the grantor passes away before the GRAT term is completed, the GRAT fails to move wealth out of his or her estate; (3) administrative complexity compared to simple gifts; and (4) the possibility that asset appreciation does not exceed the statutory hurdle rate.

### Bringing It Together: Design, Sequencing and Governance

Successful family business wealth transfer planning is a bespoke and hybrid approach. Many families begin with a recapitalization and then choose between an IDGT sale, a GRAT strategy, or a combination, based upon expected growth, volatility, interest rate conditions and liquidity. Generally, if a family business owner has sufficient gift/estate and GST exemption, a preference is placed on IDGT planning because it is generally more successful in passing assets to multiple generations, whereas GRAT planning may eventually cause assets to again be subject to the GST tax. That said, nothing prohibits utilizing more than one strategy.

Once again, note that adherence to all formalities is critical, and there should be sufficient time between the estate planning transaction and any liquidity event to avoid unwanted IRS scrutiny. Sophisticated wealth transfer counsel can review your specific circumstances and design a customized strategy.

*Katten is here to help you plan in the near term and execute for the long term when it comes to navigating important commercial and legal considerations for your family business, including wealth transfer and business succession. Click here to receive our extensive guide,* The Great Wealth Transfer: Strategies for Succession, Legacy and Wealth Generation*, coming later this year. This article was written by Michael L. Sherlock, a corporate and family office attorney in Katten's Chicago office, and Louis A. Laski, a trusts and estates attorney in Katten's Chicago office. Andrew L. McKay, a trusts and estates attorney in Katten's Chicago office, also contributed to this article.*

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