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Planning for the Liquidity Event

One of the benefits of working as an estate planner in a full service law firm is that occasionally one of your partners will refer a client in need of your skills. One of the lessons that I've tried to convey to my partners over the years is the advantage of planning before acting. This is particularly true when a client contemplates a sale.

What can an estate planner do to improve the outcome for an individual or couple who are selling an interest in a closely held company or a significant real estate investment? Tax planning! Tax planning in advance can save significant income, gift and estate taxes in perfectly appropriate ways.

Oftentimes, a client may have an interest in reducing the income tax cost of a sale of an interest in a business. If that client also has a desire to benefit one or more charities, a charitable remainder trust may provide an attractive combination of a current income tax deduction, a tax exempt trust that will pay no income tax on the sales proceeds, a secure income stream for life and a healthy charitable bequest at death.

A client might also decide that the value of the property to be sold has increased so much that the client will not want to receive all of the sales proceeds personally. Some clients would prefer to have their children receive a portion of the sales proceeds in a tax efficient way. A grantor retained annuity trust could be the solution.

In this article, I will outline these two approaches, a charitable remainder unitrust (or CRUT) and a grantor retained annuity trust (or GRAT). The CRUT is used to reduce income tax and increase the cash flows available to a selling shareholder or property owner. The GRAT is used to shift future appreciation in value to or for the benefit of children. Each of these techniques should be considered and implemented long before a sale is consummated or an agreement for sale is reached.

Charitable Remainder Unitrust

A CRUT is a tax exempt trust, typically created by an individual or a couple who will receive benefits from the trust for life. The contribution of property to a charitable remainder trust produces a partial income tax deduction equal to at least 10% of the value of the contribution. Depending upon the age of the beneficiary and the selected percentage return, the income tax deduction can equal up to one-third of the value of the contribution or more. The donor can select the amount to be paid from the trust each year to the donor/beneficiary. The selected payout rate must be at least 5% of the net value of the CRUT, payable annually or in quarterly or monthly installments, and remains fixed so long as the CRUT is in existence.

Here's an example. Married individuals, aged 75 and 72, contribute $3 million worth of stock in their company to a charitable remainder unitrust. The CRUT specifies that it will pay 8% of its net value every year to the couple and to the survivor of them. At the survivor's death, the remaining balance of the CRUT will pass to one or more public charities identified by the donor couple and the CRUT will terminate.

The gift to the CRUT produces a current income tax deduction of over $900,000. This deduction will save income tax on other income of the couple in the same tax year of the contribution to the CRUT, possibly including income generated by other shares of company stock sold by the couple.

Assuming the company was not publicly held, the $3 million contribution value probably included a discount for the lack of marketability of the stock. If it were a minority interest in the business, it would also likely reflect a minority interest or lack of control discount. If all the stock in the company were subsequently sold by all the shareholders, including the CRUT, all those discounts would likely disappear and the CRUT (and other selling shareholders) would receive full value for their shares. Let's say that by the time the company is sold, the stock contributed to the CRUT has appreciated and the CRUT receives $5 million for its shares.

The CRUT will pay no income tax on the $5 million in sales proceeds. Instead, it will invest 100% of the sales proceeds to benefit the donor/beneficiaries of the CRUT. The CRUT provides that 8% of its net assets should be paid to the donor/beneficiaries every year. In this example, beginning the first year after the sale, the CRUT would pay $400,000 per year to the donor/beneficiaries. Furthermore, the donors may have saved an additional $200,000 or more in income tax due to the $900,000 income tax deduction resulting from the initial gift to the CRUT.

Compare this to an outright sale of $5 million in stock by the donors. Without the use of the tax exempt CRUT, and assuming the sellers have a zero basis in the stock (as is often the case), the Federal and California income tax would be about $1.2 million, leaving about $3.8 million in net proceeds for the selling shareholders to reinvest. Assuming the same 8% return, the selling shareholders would receive about $300,000 annually in earnings. The CRUT has increased the income stream from the stock by about a third!

The CRUT allows the donors to receive a lifetime income stream on money that would otherwise have been paid in tax to the government. It also allows the donors to benefit their favorite charities at death. If the donors wish to involve their children in philanthropy after their deaths, the CRUT could instead distribute its assets at the death of the surviving donor to a donor advised fund at a community foundation which would allow the donors' children or other designees to provide guidance on how the charitable funds should be distributed in the future.

Grantor Retained Annuity Trust

A GRAT is used for assets that the owner would like to pass to or for the benefit of children during the grantor's lifetime, rather than retaining the assets until death and subjecting them to estate taxes. Under current law, the estate tax rate is a

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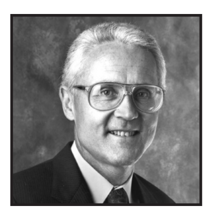
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ORANGE COUNTY BUSINESS JOURNAL

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flat 45%. The gift tax rate is also 45%. An individual may give up to $1 million in taxable gifts during life before beginning to pay gift tax and may give up to $2 million at death before paying estate tax. (Taxable gifts during life reduce the $2 million allowance at death.) (Under current law, the estate and gift tax rules are in transition. Future legislation may increase the death exemption or reduce the tax rate, but is not expected to eliminate the estate or gift tax entirely.)

Suppose the couple I described above own a business that could be sold for $20 million. Further, suppose they have children they'd like to benefit during lifetime rather than after the death of the surviving parent. Suppose they don't want to pay any gift tax or use much of their lifetime gift tax exemption to accomplish their goals. Here's a possible approach.

Each spouse contributes 25% of the outstanding stock of the company to a separate GRAT. Assuming the same discounts for lack of marketability and lack of control described above, each 25% interest is valued at $3 million. Each grantor provides that the GRAT will make two annuity payments to the grantor, one at the first anniversary of the creation of the GRAT and the second on the second anniversary. The annuity payment is specified as 54.3% of the value of the initial contribution. Assuming the value of the contribution to each GRAT equals $3 million, the taxable gift will equal about $5,000 for each spouse.

Under the terms of the GRAT, each grantor is entitled to receive a payment of about $1.6 million in cash or property at the end of the first year and an equal amount at the end of the second year. If the company stock is never sold and if the value of the stock is unchanged, the grantors will likely get all their stock back and their children will get nothing. However, if the company is sold for $20 million within the first year after the creation of the GRATs, each GRAT will receive $5 million (its 25% share of the sales proceeds).

In this case, the grantors will each receive about $3.3 million in payments, leaving about $2 million in each of the GRATs at the end of the two year term. The grantors may choose to pay the income tax from the sale of the shares owned by the GRATs. The total income tax burden created by each GRAT sale would be about $1.2 million, about equal to one of the two annual annuity payments.

In the strategy outlined above, the grantors used the GRATs to transfer a total of about $4 million to their children (or, if they wished, to trusts for the benefit of their children). The grantors have paid the income tax on the sale, so their children received the maximum benefits of the GRAT strategy free of income tax. If the grantors were to both die after the two year GRAT terms were completed, they would have saved approximately $1.8 million in estate taxes that would otherwise have been due if they had not used the GRAT strategies.

If the grantors live a number of years after the GRAT terms expire, as all might hope, they will have benefited their children long before their deaths and will have lived to see their children enjoy part of their inheritance in advance.

Using Both Strategies

It is possible to combine the use of a charitable remainder trust and a grantor retained annuity trust. By simply combining the two examples described above – a $3 million contribution to a CRUT and two $3 million contributions to GRATs, the donors could assure themselves a $400,000 enhanced income stream for life, obtain a $900,000 current income tax deduction, avoid income taxes on the $5 million sales proceeds received in the CRUT, transfer $4 million in cash or other property to their children, pay about $3.3 million in income taxes and retain about $7.6 million in liquid assets from the sale, which would also be invested to provide a safety net for the donors for their lives.

Compare this with the result if no personal planning were done prior to the sale. The couple will have sold the $20 million business, paid about $4.6 million in Federal and California income taxes, netting about $15.4 million. If the couple decided to transfer $4 million of the net sales proceeds to their children, they would exhaust their lifetime gift exemption and incur a gift tax of $870,000, leaving the couple with about $10.6 million. The government would receive a total of about $5.5 million in income and gift taxes in this latter example, compared to $3.3 million in income taxes and zero gift taxes in the prior example. Quite a difference!

Unfortunately, when an estate planner meets a client who has already sold the business, these powerful planning opportunities are generally not available. Business owners considering a sale should make the estate planner a part of the team, along with a transactional lawyer, investment banker or business broker and accountant. Advisors working with business owners on a sale would do their clients a great service to alert them to the planning opportunities that exist before the sale.

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