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With the Economy Lousy, Now is a Great Time to Transfer Your Business to Your Kid(s)

Did you notice that the title of this article does not say "Sell?" Instead, it says "Transfer." So if you are thinking of having one or more of your kids own your business some day, this article probably can become a new profit center for you and your business.

About once a month I get a call from a reader (call him Joe) of this column who wants to sell his business (Success Co.) to his kids. After a short conversation, Joe understands why a sale is a terrible idea for Joe and the kids.

Let's start with the kids. In this case Joe's son (Steve) wants to buy Success Co. for $1 million (the real fair market value). Follow these strangling tax numbers: Steve must earn $1.66 to have $1 left to pay to Joe (typically 40 percent in income tax—state and federal—on $1.66 is 66 cents in tax). Steve pays the full $1 to Joe. Steve cannot deduct any portion of this $1 because the purchase of stock (Success Co. or any other stock) is simply a nondeductible capital expenditure.

If Success Co. is a C corporation, any interest paid by Steve, in addition to the principal stock purchase amount is generally not deductible. However, Steve could deduct this interest against portfolio income—interest and dividends on other investments. Rarely do kids have such investments. But Steve can make all the interest deductible by having Success Co. elect S corporation status.

What about Joe? Steve pays his dad that $1, plus interest. Joe must pay a capital-gains tax (typically 15 percent on the dollar) and pay his top tax bracket (say 40 percent) on the interest income. Okay, Joe has 85 cents left after paying the capital gains tax on the $1. If Joe doesn't spend that 85 cents, the IRS gets up to 55 percent (using 2011 rates) for estate taxes. That's another 47 cents for the tax monster, leaving Joe's heirs with only 38 cents.

Let's review. Steve must make $1.66 for Joe to leave his family 38 cents. That would turn into $1,660,000 for Steve—with a $1 million price for Success Co.—to make while Joe's family only gets $380,000. Lousy tax planning.

Now let's put some meat on them bones. Suppose Success Co. is worth $6 million. Yes, Steve has to earn a stratospheric $10 million ($6 million times 1.6667) for this family to keep $3.8 million.

Take a minute to apply the above formula to your own Success Co. I know, you don't want to go there. But fortunately, the tax law has a flaw, offering an easy and better way to transfer your business to your children.

When should the transfer be made? If you are lucky enough to own a family business currently enjoying big profits or larger profits each year, the sooner you make the transfer, the better. You will freeze the value of your business and stop the potential loss of estate taxes on your increasing wealth. Unfortunately, most family businesses are suffering reduced profits in these tough economic times. Obviously, the value of such businesses are at a low point, giving you a window of opportunity to make a tax-advantaged transfer to your children.

Sounds good. But, if you are typical, under no circumstances do you want to give up control of Success Co. Let's walk through the simple three-step process

for transferring your business (get it out of your estate), yet keeping absolute control for as long as you want.

Step No. 1—We recapitalize Success Co. (the old common stock disappears) and is immediately replaced by voting stock (say 100 shares) and nonvoting stock (say 10,000 shares). This is a tax-free transaction. Now, Joe can keep the 100 shares of voting stock and control. Joe will transfer the 10,000 shares of nonvoting stock to Steve. (Note: This example assumes Joe owns 100 percent of Success Co., but the concept works just fine if Joe owns a lower percentage.)

Step No. 2—If you are a C corporation, elect S corporation status. Joe's Success Co. is already an S corporation.

Step No. 3—Joe sells his nonvoting stock to an intentionally defective trust (IDT), which is easy to do and has a long list of tax advantages. We'll cover only the most important ones:

1) Huge discount for tax purposes. The nonvoting stock, because of various discounts allowed by the tax law, has a value of about 60 percent of the stock's real value. For example, if Success Co. is really worth $7 million, the nonvoting stock would have a value for tax purposes of only $4.2 million (after a 40-percent discount of $2.8 million). An urgent note: the Obama administration is proposing a tax law change that will eliminate these discounts. My suggestion: Act quickly—this tax-saving opportunity could soon be history.

2) Tax-free to Joe. The IDT will pay for Joe's nonvoting stock with a $4.2 million note. The note will be paid, including interest, to Joe by the IDT, using dividends from Success Co.

Typically, it takes five to eight years to pay off the note. All the payments received by Joe—for the note, plus interest—are tax-free. A great deal.

Wait, it gets better. When the note is paid off, the trustee of the IDT distributes the nonvoting stock to the trust's beneficiary, Steve, with no tax consequences. How much taxes will Steve save? A whopping $2,772,000— 66 percent of $4.2 million, using the formula at the beginning of this article.

Here are some more goodies, tax and otherwise, that make an IDT an economic hero:

3) The ultimate transfer of the stock to Steve is not considered a gift for tax purposes, leaving your annual gift exclusion ($13,000) and lifetime exemption ($1 million)—double if you are married—available for other estate-planning strategies.

4) A big deal for community property states like Texas and California, the stock transfer to Steve is not in the community, which means Steve's wife has no interest in the stock.

5) An IDT works just as well if you want to transfer all or a portion of your business to other people, most commonly other shareholders (related or not), employees (usually the one or two top key people) or even a tax-advantaged sale to a buyer of Success Co.

Actually, I could write a small book about the wonders of an IDT. Done right, there is no downside. One warning: Only work with experienced professionals.

Want to learn more about how to shield yourself and your family from the IRS when you transfer your business? Browse www.taxsecretsofthewealthy.com. If you can't get a good answer from your professional advisors, call Irv at 847/674-5295 to discuss your business transfer problems. **MF**

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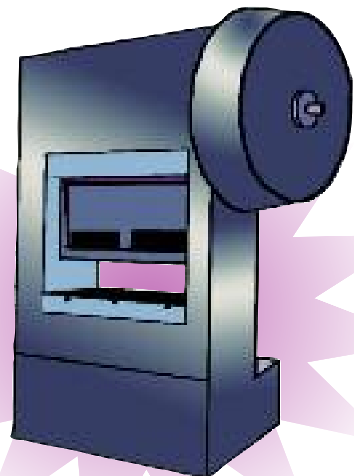

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