

Using a GRAT to Transfer Company Ownership

A succession planning strategy for business owners



Succession planning can be an exciting, satisfying process for owners of closely held businesses, but it also involves difficult issues that must be tackled head on. One of the major challenges that entrepreneurs encounter is determining the best way to pass on the ownership of their business to their children or other heirs.

The business owner can choose any number of methods of transferring ownership of a company, while simultaneously potentially mitigating gift and estate taxes and probate costs. One vehicle that may be useful is a form of trust called a grantor retained annuity trust, or a GRAT. A GRAT may be appropriate for business owners who:

Key takeaways

- One of the major challenges that entrepreneurs encounter is determining the best way to pass on the ownership of their business to their children or other heirs
- One vehicle that may be useful is a form of trust called a grantor retained annuity trust, or a GRAT
- A GRAT can be a favorable way to make a large gift with a low gift tax cost to the business owner
- Have a business currently that is likely to appreciate rapidly
- Would like to maintain control of the business and are interested in passing shares of the business (with the underlying value of those shares) to their beneficiaries
- Wish to maintain an income stream from the business but are comfortable parting with growth in the value of the business
- Would like to take advantage of the difference in gift tax value and the fair market value of the business through minority, marketability, and control discounts
- Would like to keep the transfer of ownership from becoming public
- Are interested in protecting the business against the claims of creditors
- Have a life expectancy that likely exceeds the GRAT term



How does a GRAT work?

In this case, the business owner—known as the grantor or settlor—would make a gift of company stock to the GRAT. A GRAT is an irrevocable trust, meaning it cannot be changed or revoked, and the trustee is given sole control of the trust.

The grantor would receive an annuity from the trust for a certain number of years. The annuity may be paid in a fixed dollar amount or as a specific percentage of the initial value of the trust's assets. If income from the GRAT each year is not enough to pay the annuity, trust principal must be used to make the payments. This helps to ensure that the grantor receives a steady stream of income.

At the end of the GRAT term, the assets in the trust, including all appreciation, go to the beneficiaries. For example, shares of the business that were not needed to pay the annuity will pass either outright or in further trust to the GRAT beneficiaries free of any gift and estate taxes. So long as the grantor survives the term of the GRAT, the appreciation is removed from his or her estate with a minimum tax cost, limited economic risk, and no loss of control.

When the GRAT is initially funded, the Internal Revenue Service considers it to be a gift to the beneficiary of a remainder interest. To value the remainder interest, the property in the trust is assumed to grow at a federally established rate, set monthly, called the Section 7520 rate. Assets contributed to the GRAT should have the potential for appreciation above the Section 7520 rate. Other valuation factors may include the age of the business owner when the trust is created, the number of years that the owner will receive the annuity, and whether the remainder beneficiaries are members of the owner's family. In

addition, closely held stock contributed to a GRAT may receive favorable minority, marketability, and control discounts that allows a greater transfer at a reduced gift tax value.

A GRAT is a powerful tool particularly in a lower interest rate environment. However, even in a higher interest rate environment, a GRAT could be a powerful tool if the assets significantly appreciate beyond a higher Section 7520 rate.

A GRAT is a favorable way to make a large gift with a low gift tax cost to the business owner. Where the business owner exhausted or otherwise has limited lifetime gift exemption remaining, a GRAT could be a solution by structuring the value of the remainder for gift tax purposes as close to zero as possible.

Often, business owners have most of their wealth concentrated in the business. A GRAT can easily accommodate a gift of shares from the business owner. This strategy can be repeated by creating new GRATs to gradually transfer additional shares of the business to the business owner's beneficiaries over time while maintaining an income stream to meet the owner's lifestyle needs.

It should be noted that a valuation of the closely held stock must be completed for purposes of establishing a GRAT. It may also be required if the GRAT distributes closely held stock back to the grantor to meet the annuity payment (if the business is appreciating rapidly but not paying a shareholder distribution or dividend). A benefit of this approach is that as a grantor trust, the distribution of appreciated stock to pay the annuity to the grantor would not incur a taxable gain. It is a complex process that requires expert advice.

A few considerations: For the GRAT to be successful, the grantor must survive the trust term so careful planning for trust duration and evaluating grantor health is important. Generally, the value of the GRAT is “pulled” back into the estate of the grantor if he/she does not survive the trust term. A successful GRAT’s assets appreciate above the Section 7520 rate. It is possible that the GRAT assets underperform and do not pass appreciation to the beneficiaries. However, there are options to “fix” the GRAT, for example, through asset substitution. A GRAT is an irrevocable trust and not easily modified. It can offer asset protection when established in a state that allows for a self-settled trust to be protected from creditors, such as Delaware. Assets in a GRAT established in a non-asset protection state may receive asset protection if the remainder interest is transferred in trust to the beneficiaries at the end of the GRAT term.



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If you own a business that you wish to pass on to your heirs, a GRAT is certainly worth looking at. But keep in mind that GRAT is just one of any number of tools that can be used as part of a broader strategic estate planning process, and you should be sure to consult with your estate, tax, and financial planning professionals.

Data source: www.irs.gov

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