



Death and Taxes vs. Preserving Wealth: The Final Exit Planning Contest

Full disclosure: Wealth preservation planning can't help any of us cheat death, but it can help business owners avoid taxes and achieve financial security.

The ideal Exit Plan (one that provides the business exit you desire) includes a strategy to help you preserve your hard-earned wealth from unnecessary taxation when it is transferred to your family. However, to preserve wealth, business owners must take steps before they actually have wealth. In other words, to realize all of the potential benefits of various wealth preservation techniques, owners must make plans before they convert the value of their businesses to cash.

The foundation for wealth preservation planning is found in the answers to two of the questions in Step One of The BEI Seven Step Exit Planning Process™:

1. How much wealth do you want when you exit your company? (Additionally, for parents, how much wealth do you want your children to have?)
2. How long before you leave your company?

Using your answers as guideposts, you and your advisors can choose the planning technique that will best preserve your wealth, provide for your family, and minimize your tax bill. Let's look at how one fictional owner used wealth preservation techniques to do exactly that.

George recognized that he'd waited too long to begin gifting part of his company to his kids. A week earlier, George's CPA told him that, based on the company's pre-tax cash flow of \$2 million per year, his company could be worth as much as \$12 million to a third party.

After recovering from the shock of this realization, George understood that (a) he didn't need nearly that much cash to retire in style and (b) if he didn't transfer at least half the value of his business before selling, his family could be looking at millions in gift or estate taxes.

To remedy this situation, George and his Exit Planning Advisor did the following:

- Hired a certified business appraiser to assign a conservative but supportable value to the company.

Result: Based on tax case law and valuation principles applicable to George's situation, the appraiser valued the transfer of a 49% minority interest (i.e., less than controlling) at \$4 million. In her opinion, the appropriate minority discount was 35% of the full fair market value (assumed to be \$12 million) of the stock. Using the 35% discount, George could give away nearly half of the company to his children (a gift valued at approximately \$4 million) and would pay no gift tax (based on a law that provided for a \$5 million lifetime gift-tax exemption). While George was happy with the idea of not paying a tax, he didn't relish using most of his lifetime gift- and estate-tax exemption, and wanted a better answer. So, he took another step to avoid needlessly wasting this valuable exemption.

- Created a grantor-retained annuity trust (GRAT). (See "GRAT Note" at the end of this article for more-detailed information.)

Result: By using a GRAT—perhaps the most useful piece of the wealth preservation puzzle—George would avoid using a significant part of his \$5 million lifetime gift tax exclusion and would still give almost 50% of the company to his children.

Through wealth preservation planning performed well in advance of his exit, George was able to:

- Transfer nearly one-half of his business, with a fair market value of \$9–12 million, to his children over four years (a time frame George chose) using little or none of his lifetime exemption.
- Receive all of the cash flow from the company during that four-year period, because the annuity payment to George was designed to equal the amount of cash flow expected from the stock transferred into the GRAT (George needed this income to achieve his financial security Exit Objective).
- Transfer the trust asset, nearly one-half of the company, to trusts for his children, completely free of any gift tax.

George established these trusts when he created the GRAT to carry out his wishes regarding when (and whether) his children would receive money from those trusts.

Techniques such as GRATs and the careful use of minority discounts (as well as many other estate tax–avoidance techniques) only work as intended if they are put in place well before you exit your business. These techniques also work well when two objectives—in this case, George’s financial security and his desire to provide for his family—must be achieved in tandem.

We can provide you with additional information about transferring wealth to children and/or protecting as much wealth as legally permissible from unnecessary taxation. Contact us today.

GRAT Note

In this note, we provide additional details about how and why a GRAT can help achieve an owner’s twin objectives: financial security and providing for one’s family.

A GRAT is an irrevocable trust into which the business owner (and the trustee of the GRAT) transfers some of his or her stock. The GRAT must make a fixed payment (i.e., annuity) to the owner each year for a predetermined number of years. At the end of that period, any stock remaining is transferred to the owner’s children.

Stock transferred into a GRAT is treated as a gift. The amount of that gift is the value of the asset transferred minus the present value of the annuity that the owner will continue to receive. (George’s advisors made sure that the present value of the annuity paid out over four years almost equaled the value of the stock transferred into the GRAT. In doing so, George gave only a nominal and non-taxable gift.)

The key to a GRAT’s success is to transfer an asset that appreciates in value and/or produces income in excess of 120% of the federal midterm interest rate, which fluctuates monthly.

Brought to you by:



Chris Rich ChFC, MSFS, CFP®
chris.rich@goldenhawkprofessionals.com

GoldenHawk Professional Associates, LLC
3254 East Cactus Road
Phoenix, Arizona 85032

Office Phone: 602-923-8300

Chris Rich is the Founder and President of **GoldenHawk Professional Associates, LLC**. He has been serving the business owner/ CEO community for nearly 25 years, with expertise and wisdom. He holds numerous professional designations, including Certified Financial Planner (CFP®), Master of Science in Financial Services (MSFS), & Chartered Financial Consultant (ChFC).

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