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TO: OUR CLIENTS AND FRIENDS
FROM: JACKSON M. PAYNE
DATE: AUGUST 15, 2010
RE: FINANCIAL STRATEGIES FOR YOUR LIVES AND BUSINESSES

**THE FINANCIAL STRUCTURING OF THE TRANSFER OF THE
FAMILY BUSINESS TO YOUNGER GENERATIONS**

While the economic downturn has left many businesses with more debt than cash, the lower valuation offers a family business owner a chance to reduce the size of the estate by gifting shares in the corporation to the next generation. The value of the gifts might be lower than it was a few years ago, and interest rates are at all-time lows for gift transfers.

Owners can set up their gifting through grantor trusts with family members as beneficiaries. In this structure, the grantor owns the assets for income tax purposes, but the transfers are recognized for gift and estate tax purposes, so that the assets are not subject to estate taxes. A grantor trust also offers protection against potential creditors and fiduciary oversight.

What if an Owner who has some children who are involved in the business and others who are not. Here is an example of how such a trust can create an equitable distribution even in a family where not all of the children are closely involved with the business: Mr. Owner owns 100 shares of his company, an S corporation having a fair market value of \$5 million. He also owns commercial real estate with a fair market value of \$5 million. He has four children, two active in the business and two not, and he doesn't want the children who are inactive in the business to be owners. He can recapitalize the corporation to create a split between voting and non-voting stock. Transferring the non-voting stock might result in a lower value, which is desirable for the purpose of wealth transfer. So Mr. Owner creates 90 shares of non-voting stock and 10 shares of voting stock in the S corporation. He can transfer

all of the non-voting stock to a grantor trust naming as beneficiaries the two children who are active in the business. Then he can transfer the commercial real estate to a limited liability company (LLC) in exchange for a 10% voting membership interest and a 90% non-voting membership interest. That non-voting membership goes into a grantor trust with the other two children as beneficiaries. At his death, Mr. Owner would complete the transfer of his business by leaving the voting stock in the corporation to the two children active in the business, while the other two children receive their remaining inheritance through the voting membership interest in the LLC.

Grantor retained annuity trusts (GRATs) are also popular now, as is generally the case when interest rates are low, because earnings that are higher than the prevailing interest rates when the trust is set up will not be subject to estate tax. In this type of grantor trust, the grantor retains the right to receive a fixed dollar amount for a specified period of time, after which his interest terminates and the asset is distributed to the beneficiaries or the trust continues. A GRAT is a useful technique if the head of the family business wants to step down but continue getting income from that business. However, the caveat in using a GRAT to draw down the value of an estate is that if the grantor dies during the term of the trust, at least some of the assets will still be included in the estate and thus subject to estate taxes.

Most advisors warn against allowing young children or any family members who don't work for the business to hold voting stock. Not only is there risk of exposure to liabilities, but also each member of the partnership has an equal say in the management of the partnership. But giving equity interest only to heirs who are going to run the business isn't always possible, because the business is often the family's main source of wealth, and often the most illiquid asset. When that is the case, consideration should be given to transferring shares with a series of put and call options designed to discourage casual buying and selling. The children who are not active in the family business have the right to sell their shares at any time, but at a put rate that is somewhat below fair market value, while those who are running the business can offer to buy out their siblings, albeit at a call price that is slightly above the market value.

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