For closely held business owners, the estate planning process is frequently about more than who inherits their assets at their death. As part of this process, the owner often directly addresses the ownership of the business interests. Many business owners, however, do not realize that engaging in planning well in advance of an anticipated sale of the business can serve to protect the business itself as well as the owner’s family. The primary benefit to this planning is minimizing potential tax liability. Additionally, following a sale, business owners should engage in planning to protect the sale proceeds from creditor claims and minimize any potential tax liability.

**Pre-Sale Planning Techniques**

Before the sale of a closely held business, a business owner may wish to implement certain estate planning techniques to maximize the wealth transfer in a tax efficient manner. It is important to consider and implement these techniques as far in advance of the sale as possible. As the sale approaches, a business owner should also consider the structure of the sale and income tax consequences.

**Gifting:** Gifting stock or other ownership interests in a closely held business prior to a sale can have beneficial estate and income tax consequences for both the business owners and the gift recipients. Under the current law, in 2018, each business owner may give $15,000 per calendar year to any number of individuals without incurring gift tax. This amount is often referred to as the **annual exclusion amount**. This amount is indexed for inflation. Gifts to an individual in excess of this amount will reduce the business owner’s remaining lifetime gift and estate tax exemption amounts. In 2018, each business owner has a total lifetime gift/estate tax exemption amount of $11,180,000. Again, this exemption amount is indexed for inflation each year.

A closely held business owner may choose to gift the business interest to his or her family members, either outright or to a trust created for their benefit, taking advantage of the annual exclusion and the lifetime gift/estate exemption. Gifting business interests removes not only the value of the interest from the owner’s taxable estate for federal estate tax purposes, but also removes any subsequent income and appreciation related to those interests.

The impact of a significant lifetime gift for transfer tax purposes is based on the value of the asset as of the date of the transfer. Minority or non-voting interests in a closely held business entity are ideal assets to gift. This is because, under current law, the value of the underlying assets of the business entity may be discounted when determining the value of the business interest for gift tax purposes. By law, the value assigned for gift tax purposes is its “fair market value,” or the value at which a willing seller will sell, and a willing buyer will buy, the property being transferred. Since a minority or non-voting interest in
a closely held business is difficult to market to any non-related party, and since an owner of such an interest has no control rights with respect to the entity, the interest has a fair market value less than its pro-rata share of the entity’s underlying assets.

While both an outright gift and a gift in trust remove the value of the business interest from the business owner’s estate, gifts to an irrevocable trust can have significant advantages. The trust can be structured so that the assets would be shielded from the claims of the beneficiaries’ creditors and will not be subject to division in the event of divorce. The trust may contain a spendthrift clause, prohibiting a beneficiary from selling his or her interest and preventing a creditor from reaching the trust assets.

In addition to the creditor protection benefits of a gift to an irrevocable trust, there are important transfer tax benefits to the business owner. An irrevocable gift trust can be structured so as to remove the trust assets from the business owner’s taxable estate; moreover the gifted assets can be excluded from the taxable estate of the family members who are the trust beneficiaries. Such a trust is sometimes known as a “dynasty trust.” This type of irrevocable trust is often prepared to avoid a separate transfer tax, known as the generation skipping transfer (“GST”) tax, which applies to transfers to grandchildren and further descendants. However, the application of the GST tax can be avoided by allocating GST exemption to the initial transfers to the irrevocable trust. Similar to the lifetime gift/estate tax exemptions, in 2018, each person has $11,180,000 in GST exemption. This amount is also indexed for inflation each year. By allocating this GST exemption to all transfers to the irrevocable trust, the closely held business owner can avoid transfer taxation for as long as the trust lasts. The trust can be designed to last in perpetuity.

To further maximize the tax savings with the gifts, the irrevocable trust could be structured as a grantor trust, meaning that the business owner who creates the trust (the “grantor”) would continue to pay the income taxes on the earnings in the trust as though he or she still owns them. These payments can be made without gift tax consequences or reduction in the annual exclusion amount otherwise available. So, for example, if the irrevocable trust is structured as a grantor trust and owns only the gifted business interests, the business owner would continue to pay the income tax on the interest and dividends related to the business interest. In addition, because of the grantor trust structure, at a later date, income tax planning can be implemented, such as swapping high basis assets with trust assets having a low basis.

Alternatively, the trust could be structured as a separate taxpayer that would pay its own income taxes or pass the income tax burden to its beneficiaries by making distributions to the beneficiaries. This could be advantageous if the trust beneficiaries are at a lower tax
rate or possibly reside in a low or no income tax state. If the grantor is unsure whether he or she will always be willing to pay the income taxes on behalf of the trust, the grantor can structure the trust as a grantor trust initially and later renounce the powers that cause it to be taxed that way, causing the trust to then become a separate taxpayer.

To implement the type of planning described above, the business owner could begin an annual gifting program to transfer their interest in the business over time, utilizing the annual exclusion amount, thereby retaining their lifetime estate/gift tax exemption.

**Grantor Retained Annuity Trust:** Another popular method for transferring interests in closely held businesses in a tax-efficient manner is by using a grantor retained annuity trust ("GRAT"). A GRAT is an irrevocable trust that is limited in duration. As grantor, the closely held business owner would establish the GRAT and transfer to it property, such as business interests. The closely held business owner would retain the right to receive an annuity payment for a fixed period of time. Accordingly, the value of the gift is reduced by the value of the annuity retained, as calculated for tax purposes. At the end of the term, the assets remaining in the GRAT pass to the individuals designated by the closely held business owner gift tax free.

Neither estate nor gift taxes are due at the end of the GRAT term. For income tax purposes, the closely held business owner is considered the owner of the GRAT and is taxed on its income. Because of this, the closely held business owner’s receipt of the annuity is a non-taxable event. The value of the retained annuity is determined by the IRS tables based on an interest rate known as the Section 7520 rate. It is possible to structure the required annuity to the closely held business owner so that there is no gift for tax purposes upon the initial transfer to the GRAT (known as a “zeroed-out GRAT”).

Generally, it is preferable to fund a GRAT with assets that are going to increase in value. By using a zeroed-out GRAT, the grantor can essentially transfer all appreciation on the gifted property in excess of the 7520 rate to the beneficiaries of the GRAT free of gift tax, removing the value of such appreciation from his or her estate.

However, if the closely held business owner dies before the end of the GRAT term, at least a portion (and potentially all) of the property in the GRAT will be included in his or her taxable estate. A further limitation of the use of a GRAT is that the transferred assets, though excluded from the closely held business owner’s taxable estate (assuming the closely held business owner survives the term of the GRAT), may be included in the taxable estates of the beneficiaries of the GRAT, due to the inability to allocate GST exemption to the GRAT.

The use of a GRAT can be advantageous for the transfer of a closely held business interest, especially where the interests are likely to appreciate. Under these circumstances, the use of a GRAT may provide a method for transferring significant wealth tax-free or nearly tax-free.

**Installment Sale to Defective Grantor Trust:** Another popular technique to remove from the owner’s estate a closely held business interest that is anticipated to appreciate is by an installment sale to a Defective Grantor Trust. Under this technique, the closely held business owner sells the business interest (such as
stock) to a trust that he or she creates, as grantor. The trust purchases the stock in exchange for an installment note payable to the grantor. In addition, the business owner will make a gift of cash or marketable securities with a value equal to at least 10% of the value of the stock or other assets sold to the trust. This gift ensures that payments due to the business owner under the promissory note can be made by the trust. The trust is structured as a grantor trust so that there should be no income tax consequences of the sale or interest payments on the note. Further, payment of the trust’s income tax provides an additional gift-tax-free benefit to the beneficiaries.

Generally, it is most beneficial to sell closely-held stock that is likely to appreciate significantly. All appreciation in excess of the promissory note’s interest rate will pass to the beneficiaries of the Defective Grantor Trust free of gift tax. Again, it is possible to engage in income tax planning such as swapping high basis assets with trust assets having a low basis.

Additionally, an installment sale to a Defective Grantor Trust can take advantage of valuation discounts. Like the other techniques discussed, the value of stock or other non-controlling business interests, for gift tax purposes may be subject to a discount for a lack of marketability and a lack of control.

Finally, unlike the GRAT, GST tax exemption can be allocated to the Defective Grantor Trust at the time of the initial transfer, so that none of the assets in the trust will be included in the business owner’s estate or the estate of the family members who are the trust beneficiaries, for as long as the Defective Grantor Trust lasts. The Defective Grantor Trust can be designed to last in perpetuity.

Other Techniques to Consider: In addition to the techniques mentioned above, there are several other pre-sale techniques available to closely held business owners. For example, business owners who are charitably inclined have techniques available that may provide for both income and transfer tax savings. Some of these techniques include making charitable contributions of business interests pre-sale to charitable lead trusts, charitable remainder trusts, private foundations or donor advised funds. Another technique for business owners to consider is the use of the Beneficiary Defective Inheritance Trust (“BDIT”), a third-party settled irrevocable trust that is designed to freeze the value of assets for transfer tax purposes and provide creditor protection.

Post-Sale Planning Techniques

The ability to engage in important income and transfer tax planning and the desired benefits do not end once the business has been sold. Post-sale planning can also involve asset protection planning. Importantly, all of the pre-sale techniques discussed above can be implemented after the sale using the sale proceeds, but this timing presents less opportunity to leverage valuation.

Asset Protection: As mentioned above, third-party irrevocable trusts established for the descendants of the closely held business owner can be structured to provide asset protection from creditors and in the event of divorce. Other techniques exist that provide asset protection for the closely held business owner as well.

Domestic Asset Protection Trust: In most states, if an individual contributes assets to an irrevocable trust of which he or she is a beneficiary, a creditor can reach the maximum amount that can be distributed to the
individual’s benefit. However, several states, including Missouri, have altered this rule to recognize a type of self-settled trust with asset protection features – a Domestic Asset Protection Trust (“DAPT”). Under Missouri law, all of the assets of an irrevocable trust will be protected from the grantor’s creditors, even if he or she is a beneficiary, if: (1) there are additional beneficiaries of the trust while the grantor is alive and after the grantor’s death, (2) the grantor’s interest in the trust is completely discretionary, (3) the grantor does not have the right to amend or revoke the trust, or withdraw any of the trust assets, and (4) the grantor is not a trustee. It is also important that the trustee be located in Missouri and that the trust does not own real estate or other assets located in a state that does not recognize DAPTs.

**Family Limited Partnerships and Limited Liability Companies:** Another popular asset protection technique is creation of a closely held business interests for the family’s investments, such as the family limited partnership or the limited liability company. Assets owned by a limited partnership or limited liability company are not owned by the individual limited partners or members, protecting the assets from the personal creditors of an individual partner or member. Thus, if a post-sale closely held business owner contributes assets to a family limited partnership, he or she no longer owns the assets and creditors cannot attach those assets, despite the fact that the post-sale closely held business owner may retain control over the assets.

Many closely held business owners utilize the family limited partnership because it provides continuity, consolidates management, and proactively implements succession planning. The family limited partnership allows a closely held business owner to transfer marketable securities and other property to their family and yet retain some central management authority. The business owner may choose to gift limited partnership units to family outright, or to trusts for those beneficiaries. The gift of a limited partnership unit would be discounted for valuation purposes, since the General Partner controls the partnership.

In addition, the limited partnership units also provide the business owner’s family with asset protection. In the event of a lawsuit or divorce, typically a creditor is unable to reach a partner’s underlying assets in the partnership, and at best only receives a “charging order”, entitling the creditor to any distributions actually made by the General Partner (who frequently does not make any distributions until the lawsuit is settled). This is unlike stock, where the creditor would have the ability to seize stock and exert voting control, potentially causing the corporation to be liquidated.

Business owners who choose to use the family limited partnership should be careful to not create adverse estate tax consequences by retaining certain incidents of ownership at the time of death. In order to reduce the risk of these consequences, the business owner must have a nontax reason for creating the family limited partnership. The business owner should properly create and administer the family limited partnership and respect the partnership as a distinct entity.

**Fraudulent Transfer Considerations:** Any asset protection planning techniques implemented must be able to withstand fraudulent transfer rules. If a transfer is found to be fraudulent, then the transfer will be “undone” to the extent necessary to satisfy the
creditor’s claim. A court may also require the fraudulent transferor to pay the creditor an amount necessary to make them whole. Under Missouri law, a transfer is fraudulent if the transferor has the intent to hinder a creditor. This is referred to as a claim for “actual fraud” and is proven by establishing certain “badges of fraud.”

A transfer is also fraudulent if the transferor does not receive reasonably equivalent value in exchange for the transfer and: (1) engages in a transaction that leaves his or her remaining assets “reasonably small” in relation to the transaction; (2) at the time of the transfer it was foreseeable that he or she would incur debts beyond his or her ability to pay them as they became due; or (3) becomes insolvent (debts exceed assets) after the transfer. The term “transfer” encompasses most asset protection techniques, including making gifts, funding an irrevocable trust, transferring property into joint names, and converting an asset that is not exempt from creditors into an exempt asset. As such, care must be exercised when implementing techniques intending to shelter assets from creditor claims.

**Continuing Need for Transfer Tax Planning:** Despite the recent favorable tax legislation, transfer tax planning remains an important consideration for closely held business owners. Basic estate planning, such as wills, trusts and collateral documents, should be implemented and/or updated. Many times the dispositive terms of the business owner’s estate plan reflected their wishes for the continuation of the business —both with regard to who received the business interests and who acted as the fiduciary over the business interests. The business owner’s preferences and direction may change drastically once the sale has occurred and the character of the assets has changed dramatically. It is for this reason that a business owner should revisit any prior plan he or she has created, or create one if one was never implemented.

**Conclusion**

The closely held business owner has many techniques available to address pre- and post-sale concerns while protecting both the business and family interests.