

GRATS Avoid Estate Taxes on S Corp Transfers

By Stephen M. Margolin

Utilizing a Grantor Retained Annuity Trust (GRAT), a business owner can transfer a significant interest in an S corp to his children, at slight or no tax burden, while retaining complete control. A Jan. 8, 1992, IRS final regulation confirmed the way to pass S corporation shares from an older generation to a younger generation.

A GRAT is a trust in which the grantor retains an annuity interest for a term of years. The parties to this trust are the grantor-parent (the term holder), the trustee, and the remaindermen (children). The parent enjoys the benefits of the trust for its term and thereafter the transferred property goes to the remaindermen.

Maintaining Control

Assume the parent owns in excess of 51 percent of the business. He can make a significant gift of his ownership interest and retain control by issuing and transferring non-voting common stock. Non-voting common stock is the same class and quality as voting common stock but carries no vote. The parent could maintain control by issuing one non-voting share for each voting share. In this way he transfers significant share value as a gift.

The issuance of non-voting common stock requires an amendment to the articles of incorporation but constitutes a tax-free dividend. Moreover, the issuance of non-voting shares has no effect on the S corporation status of the company.

A Valuation of Shares

A gift of less than 50 percent of the outstanding shares is not in proportion to the value of the company as a whole because of discounts for minority interests and a lack of marketability. Business appraisers generally think this supports a discount in excess of 25 percent. Assume the S corporation is worth \$6 million and you wish to transfer 25 percent, or \$1.5 million. An outright gift equals \$1.125 million ($\$1.5 \text{ million} \times 25 \text{ percent minority discount} = \$375,000$; $\$1,500,000 - \$375,000 = \$1,125,000$).

Under Chapter 14 of the Internal Revenue Code the estate/gift tax upon the formation of the GRAT is determined under actuarial tables. The ultimate taxable gift for estate/gift purposes is the determined remainder interest.

For example, assume your owner is age 60, he owns 100 percent of the S corporation valued at \$6 million with net income of \$525,000. He transfers 25 percent of the S corporation's outstanding shares to a GRAT. He retains a 10-year term interest, paying him \$131,250 per year ($\$525,000 \text{ taxable income} \times 25 \text{ percent}$). Let us assume a discounted value of \$1.125 million ($\$1.5 \text{ million} - \$375,000$). This produces a retained interest of \$817,280. (This figure comes from the Internal Revenue Service actuarial tables.) The remainder interest (the gift) is \$307,720 ($\$1,125,000 - \$817,280$). The grantor could almost double his \$307,720 (25 percent of the company) gift to his children without a tax, if desired. This is because of the lifetime gift/estate tax exemption of \$600,000.

After the expiration of the parent's term estate, the shares transfer to the remaindermen (the children) in the relative ownership percentages that the parent establishes for them.

It's important for the parent to survive the term. If he doesn't, most of the transferred share value will be included in his estate. As a hedge, therefore, insurance could be purchased. At the end of the term, of course, the policy could be discontinued, but our experience is that more insurance is then needed because of growth in his other assets.

The trust term could be shorter or longer. Any gift in trust with a longer term may be zeroed out. That means the remainder interest (the gift) is zero, inasmuch as the grantor consumed all the value during his term estate.

How Much Can Be Saved?

The significance of this transaction is dramatic in light of the 55 percent tax on estates over \$3 million. If the going concern value of the com-

pany doubled to \$12 million after the end of the 10-year period, the value of the gifts to the remaindermen would not correspondingly increase, because the value of that 25 percent interest gift at \$307,720 was frozen when it was contributed into trust.

This represents a new and viable route for agents to pursue when they are looking for ways to help protect the estates of their clients and preserve them for their heirs. With GRATs, backed by life insurance, an owner can transfer a significant interest in an S corporation to the next generation at slight or no tax burden, while maintaining full control. He hasn't relinquished anything, but look at what he has saved.

Stephen M. Margolin is a business, estate, and employee benefits attorney whose practice involves the tax and business affairs of closely held companies and their owners. He is a former field agent and an instructor and lecturer on advanced theory for the Internal Revenue Service. He is a partner at Chuhak & Tecson, P.C., Chicago, Illinois 60606.