A January 1992 regulation allows owners to transfer a significant share value to the next generation at slight or no tax burden.

Use GRATs To Reduce S Corp Taxes

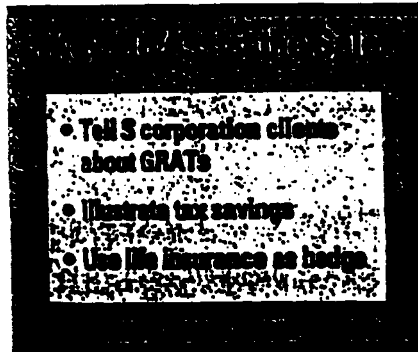
By Stephen M. Margolin

You can now show your S corporation customers how to reduce their taxable estates with Grantor Retained Annuity Trusts (GRATs). A Jan. 28, 1992 final regulation on GRATs confirmed the way to pass S corporation shares from an older generation to a younger generation. Significant share value can be transferred to children, at slight tax burden, while retaining complete control of the company. In most cases, these transactions will require considerable amounts of life insurance protection.

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 (the term holder), the trustee, and the remaindermen (children). The grantor enjoys the benefits of the trust for its term and thereafter the transferred property goes to remaindermen.

MAINTAINING CONTROL

Assume the grantor 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 grantor 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.

VALUATION OF SHARES

A gift of under 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 million x 25 percent minority discount = $375,000; $1.5 million - $375,000).

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 customer is age 60, 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 into a GRAT. He retains a 10-year term interest, paying him $131,250 per year ($525,000 taxable income x 25 percent). Let us assume a discounted value of $1.125 million ($1.5 million - $375,000). This produces a retained interest of $817,280 and a remainder interest of $307,720. (These figures come from the Internal Revenue Service actuarial tables.) The grantor could almost double his 25 percent of the company gift to his children without tax, if desired. This is because of the lifetime gift/estate tax exemption of $600,000.

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

It's important for the grantor 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 must 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 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 company doubled to $12 million after the end of that 10-year period, the value of the gifts to the remaindermen would not correspondingly increase, because the value of that 25 percent interest 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 customers and preserve them for their heirs. With GRATs, backed by substantial amounts of 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. ■

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