Legal Brief

Giving Away Value Without Giving Up Control

Individuals are currently permitted to make gifts of up to $5 million free from federal gift and/or generation-skipping transfer tax. However, absent legislation extending these expanded exclusions, they will be drastically reduced in 2013 — to $1 million for the gift tax and to approximately $1.4 million for the generation-skipping transfer tax. With just over one year before these lower exclusions take effect, a limited window exists to take advantage of significant planning opportunities.

In light of the foregoing, small business owners and their advisers have been inundated with countless articles outlining the potential tax savings associated with gifting techniques designed to take advantage of the expanded exclusions. While these recommendations are certainly worth exploring, small business owners often face two significant practical obstacles when making gifts: lack of liquidity and the desire to maintain control of the business.

Individuals with sufficient liquidity can use cash to make large gifts, either outright or in trust, without any concern regarding the impact on the small business. However, the vast majority of small business owners' assets are typically tied up in their business, and selling these assets to produce liquidity for estate planning purposes is simply not an option. Even where individuals have considerable assets outside of the business, there are often both tax and non-tax factors preventing them from gifting such assets.

Individuals lacking liquidity are typically left with few alternatives and often consider gifting a portion of the ownership interest in their business in order to take advantage of estate planning opportunities. While the tax reasons for such gifts make sense, few small business owners are willing to cede control of the business to the next generation, especially if the next generation is "unproven" or not involved in the business whatsoever.

Recapitalization

One option to consider involves recapitalizing the business into both voting and nonvoting stock. The nonvoting stock has identical rights as the voting stock except that its owners have no ability to control the business. For S Corporations, such recapitalizations do not run afoul of Internal Revenue Service regulations allowing only one class of stock. The value of both the voting and the nonvoting stock is typically comparable, and is subject to discounts for lack of marketability and minority interest.

Once the recapitalization occurs, the small business owner can use nonvoting stock to transfer a significant portion of the **value** of the business to the next generation. However, the business owner retains as much of the voting stock as he or she desires in order to maintain absolute **control** over the business. This creates an ideal way for a small business owner to "fund" his or her estate plan without concerns regarding disruptions in the operations of the business. Moreover, the value of the nonvoting stock that is transferred is "frozen" for estate and gift tax purposes, and all future appreciation escapes transfer tax entirely. The existence of nonvoting stock also allows the small business owner to equalize distributions among all of his or her children regardless of whether they are involved in the business. For children involved in the business, the business owner can then incorporate additional incremental transfers of voting stock in order to slowly cede control as such children prove their aptitude.

Shareholder Agreement

Any recapitalization also involves review or implementation of a shareholder agreement in order to guard against disruptions in the operations of the business. The shareholder agreement typically contains provisions prohibiting or limiting transfers of stock to outsiders, and sometimes requires shareholders to actually work in the business. For permitted transfers, the shareholder agreement provides procedures for determining the value of and paying the purchase price for any stock transferred.

The shareholder agreement may contain different provisions for each of the shareholders, and the shares retained by the small business owner need not be subject to the same restrictions as other shares. Moreover, the small business owner can retain the ability to require non-controlling shareholders to participate in any decision to sell the business. Therefore, the shareholder agreement affords small business owners additional control over the ultimate disposition of the business.

For more information on recapitalization and/or estate and succession planning matters, contact Mike Thomas at MacDonald, Illig, Jones & Britton LLP at 814/870-7711 or mthomas@mijb.com.

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