Transferring a Closely Held Business Using a Charitable Remainder Trust

You own a business that you have built up over the years. You would like to get out of the business to retire or to focus on other activities but if you sold it you would incur significant capital gains tax on the sale. You also want to ensure that you continue to have a stream of income for your current cash flow needs as well as for retirement, but that income might cease if you sell the business. Is there a solution to maintain income and avoid or minimize capital gains taxes?

Many owners of closely held businesses find that after many years of blood, sweat and tears, they have developed a highly successful and valuable business and now are looking forward to their retirement or doing something else. But, they are faced with a challenge – if they sell their business to a key employee or other third party, they will have a significant capital gain on which to pay income taxes. In addition, the buyer probably won't have the purchase price to pay in full, and must pay on an installment basis which means that the seller's retirement income may be entirely dependent on the buyer being able to continue the business on the same successful path it had been on.

If that describes you, but you're also charitably inclined, then there is a potential solution. A gift of the business interest to a Charitable Remainder Trust (CRT) may be the answer. Let's follow how such a trust operates, and how it might enable you to accomplish your objectives:

The business owner would like to have a reliable source of retirement income for life and the life of his/her spouse.

A CRT is an irrevocable trust often known as a "split interest" trust because it has two sets of beneficiaries – income and remainder. The trust provides the income beneficiaries, usually the business owner and spouse, with an income for a set period of years up to 20, or for life. The income can be in the form of a fixed annuity (known as a Charitable Remainder Annuity Trust (CRAT)) or a variable stream of income based upon a percentage of trust assets (known as a Charitable Remainder Uni-Trust (CRUT)).

The business owner is charitably inclined.

At the end of the trust term, whatever is left in the trust (the "remainder"), goes to charity to create a social legacy.

The gift to the CRT also generates an immediate income tax charitable deduction equal to the present value of the charity's remainder interest. The present value is a complicated calculation dependent upon the trust term, the income stream, and interest rates provided by the federal government.

The business owner would like to be able to at least limit, if not avoid altogether, paying a capital gains tax.

The CRT is considered a tax exempt entity, and accordingly, pays no capital gains tax when it sells low basis assets. The CRT then reinvests the proceeds in a manner that will enable it to meet the required income payouts to the income beneficiaries. The income generated by the CRT investments may generate taxable income to the business owner under a complicated formula commonly known as the "four-tier" income distribution rules.

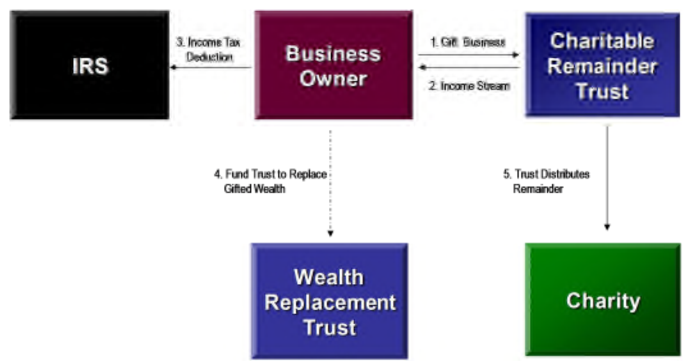
The business owner would like to leave a substantial estate to his/her children while reducing or eliminating estate taxes.

By gifting the business to the CRT the business owner has reduced the potential inheritance to his or her children. However, that inheritance can be replaced with a Wealth Replacement Trust (WRT). Some of the income received from the CRT can be used to fund the WRT so that it may have the money to purchase a life insurance policy on the business owner's life. The business owner has now effectively replaced the business with an equal amount of insurance proceeds. The WRT can use the proceeds on behalf of the beneficiaries (i.e., the children), or for estate tax liquidity needs like a typical irrevocable life insurance trust. Further, the life insurance proceeds will not be included in the gross estate for estate tax purposes if the WRT was done correctly.

Let's follow an example of how this all can work.

John and Mary own 100% of a C Corporation which they started with a nominal investment. The business today is worth \$6.0 million. They have three children, none of whom have shown any interest in the business. They would somehow like to annuitize the value of their business into a retirement income, but realize that if they sell it, they will incur a substantial capital gains tax, reducing their potential income stream. They would like to avoid income and estate taxes, provide a substantial gift for a charity of their choosing, and a substantial inheritance for which they have worked so hard, for their children. They want to have their cake and eat it too. Can they?

They create a CRT and a WRT. They gift their stock to the CRT, which then sells it for \$6.0 million, paying no capital gains tax, and pay John and Mary a 5%, \$300,000 annuity for their joint lives, or for a term of years. John and Mary then contribute a portion of that income to the WRT sufficient for the WRT to purchase \$6.0 million in life insurance on one or more of their lives. Done correctly, the death benefit is not included in John and Mary's estate when they die, and passes to their children income and estate tax-free. Using the CRT/WRT strategy, they will have accomplished all their goals.



Other Considerations

Note, that there are certain legal requirements that must be met by the CRT, such as a minimum remainder interest and a probability test that there will be a remainder to charity, so you must consult with your own tax and legal advisors to ensure that this strategy works for your particular situation. In addition, the contributions to the WRT may have gift tax consequences but typically are shielded from gift taxes through the use of provisions in the Internal Revenue Code commonly known as the annual gift exclusion amount and the lifetime gift exemption amount.

While this strategy works well for businesses organized as C corporations, it may have limitations for businesses operated as sole proprietorships, partnerships, limited liability companies (LLC), and S Corporations. For example, a CRT is not an authorized S corporation shareholder. The other business entities may cause the CRT to recognize what is known as Unrelated Business Taxable Income (UBTI). UBTI is income from a trade or business that is owned and regularly carried on by a charity or a charitable trust that is *not* substantially related to the tax-exempt work of the charity. The laws may impose a 100% excise tax on all UBTI. That should not pose much of a problem if the CRT can sell the business relatively quickly after the contribution into the CRT. However, a transaction that is considered a "prearranged sale" may cause the IRS to recharacterize the transaction such that the business owner will be caused to recognize taxable gain. A "prearranged sale" generally exists when there is already a formal agreement to sell the business before the business has been contributed to the CRT. What constitutes a "prearranged sale" depends upon the unique facts and circumstances of each case being examined.

Furthermore, any business or other asset that is encumbered by loans may not be contributed to the CRT. Otherwise, the CRT may be disqualified as a tax-exempt entity.

Conclusion

Gifting a business to a CRT may be a technique for you to consider in achieving your business and personal planning goals. You should, however, explore this technique with your professional tax and legal advisors to ensure that your particular situation meets the requirements necessary for this strategy.

Please consult with your Guardian Financial Representative if you have any questions concerning this document.

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