Wilmington Trust
MEMBER OF THE M&T FAMILY

Holistic Planning for Business Owners

Exploring wealth transfer strategies and diversification alternatives

Key takeaways

- Lack of proper planning is a surefire way to lose the family business you've worked so hard to create
- You can implement a number of strategies to help you maximize your legacy's ultimate value
- As your family and business change, so should your plans for their futures

Like many owners of closely held family businesses, you're likely working hard every day to sustain your business and help it thrive through always-changing economic conditions. The last thing you may be focused on is how you will preserve your wealth and transition your business to future generations. However, now is the time to be sure that you have a solid plan in place that will not only help your successors take over your company, but also help to mitigate the estate tax burden on the next generation.

As a business owner, you can explore a number of wealth transfer strategies and diversification alternatives to help you maximize your legacy's ultimate value.

Wealth Transfer Strategies

Mitigating potential estate and gift taxes could be an important component of your holistic plan, and there are many types of estate planning tools available that can help you transfer your wealth efficiently. The following four strategies are most relevant to business owners interested in transferring wealth, and they are particularly advantageous for transferring those assets that have the greatest potential for appreciation.

Grantor retained annuity trusts (GRATs)
A GRAT is a popular method of transferring the growth on assets held in trust to future generations at a greatly reduced gift tax cost. When you establish a GRAT to transfer all or partial ownership of your business, you make a gift of company stock (or other business interest) to the trust, pay a tax on valuation that the Internal Revenue Service (IRS) places on the estimated value of the remainder interest of the trust when the trust is established, and retain an annuity stream for life, or for a fixed term. At the end of the period, the remaining assets pass to family members outright or in further trust. A gift tax deduction is allowed for the actuarial value of the interest retained, so the amount of the taxable gift may be quite small. If the asset growth outperforms the statutory rate used to calculate the retained value, the additional growth is transferred free of gift and estate tax to the trust's beneficiaries.

The GRAT continues to be a popular planning technique because there is little downside. The owner is not required to give up interest in the business assets, and even if the business value does not appreciate as expected, the owner is no worse off than he or she would have been without a GRAT.

Charitable lead annuity trusts (CLATs)
A CLAT works similarly to a GRAT, except that the annuity goes to a charity instead of to you. With a CLAT, the trust provides an annual payment to one or more charitable beneficiaries for a certain amount of time, with the remainder interest going to family members or a family trust. Because you, as the grantor, will receive a gift tax deduction for the value of the charities' interest, CLATs are a way to "leverage" gifts to family members. They can also be structured in different ways to take advantage of income tax deductions.

Installment sale to an irrevocable grantor trust
Rather than gifting your business to your heirs, it sometimes makes sense to sell it to them (or to a trust for their benefit), especially when you can charge a very low interest rate and still have the sale respected for tax purposes. Selling shares of your company to an irrevocable "grantor trust" combines several benefits. You can sell an asset to your heirs via what is called a grantor trust and charge a very low interest rate without making an outright gift, thus not incurring a gift tax; by selling assets to the trust you do not incur any capital gains on the appreciation, and because the trust allows you to pay all income taxes on it, you can essentially increase your gift to your children by relieving them of the need to pay.

Simple gifts and loans

Outright gifts and loans to your children or other heirs are always an option, with gifting being the most straightforward. Unlike when inheriting an asset, however, the person receiving the gift will not get a "stepped-up" basis for capital gains tax purposes, so you want to choose assets carefully.

When interest rates are low, loans are also unusually attractive because you can make loans at lower interest rates. Your heirs can benefit if, however, they invest the loan amount in a manner that delivers a rate of return in excess of the interest rate allowed by the IRS. An intrafamily loan may be an effective way to help a child purchase a home or car, or perhaps even allow your child to participate in your next business venture. Alternatively, the child may invest the proceeds in the market, and any amounts above the allowed loan rate earned on the investments will not be subject to gift tax. Either technique could succeed in removing future appreciation from your taxable estate and thereby reducing tax costs. Keep an eye on the interest rate environment to utilize these techniques when rates are lower.

Diversification Alternatives: Trade-Offs Between Risk, Return, And Control

In managing your risk profile and potential return on investment, you may want to consider diversification alternatives in addition to your more tax-oriented wealth transfer planning options.

While many business owners balk at considering the sale of their enterprise, it is possible to implement strategies that diversify your wealth without sacrificing control of your company. Understanding the range of options and the tradeoffs among various transactions are important parts of a good strategic planning process. And when the time is right, exploring various options as part of the transaction process helps to ensure that you achieve the optimal outcome at the right terms and valuation.

Senior debt dividend recapitalization

Using excess debt capacity to fund a dividend to shareholders can be an excellent way to take some liquidity out of the business. There is no loss of control, but there is also no real diversification. Further, the increased leverage poses risk if there is a market downturn and may constrain the company from taking advantage of growth opportunities.

Mezzanine debt recapitalization

Mezzanine debt is a hybrid security with characteristics of both debt and equity. A cash flow-friendly financing tool, it does not significantly limit a company's senior debt availability, making it a good option to provide liquidity while preserving senior debt capacity, minimizing shareholder dilution, and maintaining operating and board control for owners. The amount of mezzanine available is generally tied to profitability and future performance, not market valuation.

Minority equity recapitalization

Selling less than 50% of your business to an institutional investor enables a business owner to gain equity diversification and a well-capitalized partner without ceding operating or board control. The prevalence of equity capital has resulted in many funds specializing in minority investing. Minority equity does not necessarily signal a reduction in valuation if a strong process is undertaken, especially with high-growth companies. An institutional investor will eventually need liquidity, so the security will have an exit mechanism (i.e., put option, which typically can be triggered after a certain amount of time).

Majority equity recapitalization

Often referred to as a leveraged buyout (LBO), a majority equity deal results in the sale of more than 50% of ownership and typically employs both debt and equity financing. The business owner(s) may maintain a minority ownership in the company post-transaction. True diversification, this deal results in loss of board control, but often allows the business owner to preserve operating control and get a "second bite of the apple" when the private equity partner sells down the road. The availability of debt and equity capital have significantly increased valuations, making LBOs more competitive with strategic deals.

Strategic sale

Selling to a strategic buyer completely transfers the ownership of a business, resulting in the loss of operating and board control. Potential synergies, lower return requirements, and debt capacity enable strategic buyers to push up valuations and pay a premium.

Lack of proper planning that incorporates all aspects of your business—and personal—finances and circumstances is a surefire way to lose the family business you've worked so hard to create. Every family and business is unique, with its own set of family dynamics and goals for the future, so it's critical to work with your wealth, tax, investment banking, and legal advisors to create the plan that's best for you. Once you put a plan in place, revisit it and update it as needed. As your family and business change, so should your plans for their futures.

Donald P. DiCarlo Jr.
President
Wilmington Trust
Emerald Family Office & Advisory®

610.519.1915 (O)
610.787.1559 (C)
ddicarlo@wilmingtontrust.com