The EXIT Planner

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# WHAT'S INSIDE

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"How much money will I get if I sell my business now?" This is a common—and most appropriate—question most owners ask before they decide to sell their businesses. The answer is usually dependent on the amount of money they put in their pockets when they walk out the front door. The net cash they receive is in turn dependent on (i) the sale price, (ii) the amount of cash received at closing (versus the amount of sale price they have to carry) and (iii) the size of the tax bite taken out of the sale proceeds.

This issue deals with the last factor—reducing taxes—by explaining how sellers can use a completely legal tax avoidance technique that is growing rapidly in popularity as business owners (and their advisors) learn more about it—The Charitable Remainder Trust (CRT). Properly designed, a CRT not only minimizes capital gains taxes upon the sale of a business interest, it can effectively eliminate the tax. Of course, if you don't mind paying up to one-third of your sale proceeds to the IRS, there's no need to read this issue.

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# SAVING MILLIONS WHILE GIVING IT AWAY

By John H. Brown

How do you leave your business with the most money possible? *Selling* it for top dollar is a pretty good answer. But it is really only half an answer.

*Keeping* as much of the sale proceeds as possible is the other half. Keeping it from Uncle Sam. It is this vitally important aspect of the exit planning process that is too often ignored. Ignored, that is, until it is too late to effect significant tax savings.

This issue of *The Exit Planner* addresses that often ignored "other part": the part of the process designed to help you hang on to as much of your hard-earned profits as possible, by giving as little as is legally required to the IRS.

## HOW MUCH CAN THE IRS TAKE?

Let's look at two scenarios: a stock sale and an asset sale. If you sell the stock of your company, there is a capital gains tax (28 percent federal and about five percent state) imposed on the gain resulting from that sale of stock. Therefore, if a business is sold for $1 million and the owner's basis (the amount paid for the stock) is non-existent, the capital gains tax rate of 33 percent means the owner is left with $670,000. Now that's the best case.

The worst case scenario is the sale of the assets of a regular or "C" corporation followed by a distribution of the net sale proceeds to the owner. In this scenario, there is first the tax (at the corporate level) on the gain from the sale of the assets. This gain is almost always substantial due in part to the depreciation already taken on those assets and due in part to the buyer's insistence that the bulk of the purchase price be allocated to the depreciable assets so that it can "write-off" the purchase price over the depreciable lives of the assets. This means the corporate income tax (which can be 40 percent or more) is imposed on the $1 million sale price, reducing the selling company's proceeds to $600,000 or so.

To add insult to injury, there is a second tax when this remaining $600,000 is distributed to the retiring owner. That tax is usually a capital gains tax (of about 33 percent) leaving the owner (who has failed to plan) with the princely sum of $400,000.

Suddenly the million dollar sale ain't lookin' so good.

Given this fact pattern, owners may actually be better off not selling the business. Instead, they live off the income the business will generate, even if the business stagnates or declines, because it will surely exceed the investment return from $400,000. What's the alternative?

Chapters Seven and Eight of *The Completely Revised How To Run Your Business So You Can Leave It In Style* discusses several techniques designed to reduce the impact of taxation when a business is sold.

But one tax savings tool (the one discussed in this issue) in the right circumstances may well be considered supreme, for it shields the business owner from the entire capital gains tax upon the sale of the business.

## THE CHARITABLE REMAINDER UNITRUST

A Charitable Remainder Trust (CRT) is an irrevocable trust which you, the business owner, fund with the stock of your company. There is a *designated payout*, or annuity rate, which you fix (again, irrevocably) when you establish the trust and which is paid to *designated individuals* (usually you and your spouse) for a *specific time period* (usually the joint lives of husband and wife).

Let's look at an example of how one owner analyzed and implemented a CRT.

### CASE STUDY

*Len and Sharon Pagano, owners of Aluminum Fabrication Co. (AFC), were approached by a large national manufacturer who offered $3 million cash for the stock of their business. To meet their targeted retirement income stream of $250,000 per year, the Paganos immediately calculated they would need an eight percent return on the $3 million.*

*The Paganos were eager to accept the offer until they realized the impact of the capital gains tax. Because they had practically no basis in their AFC stock, they would pay a capital gains tax on the entire $3 million—or almost $1 million in taxes. Suddenly they needed not an eight percent return on their investment, but a 12 percent return to achieve their desired $250,000 annual investment income amount. Even their financial advisor was unwilling to assure them of a consistent 12 percent return. What could they do to avoid the capital gains tax? The Paganos created a CRT which followed Steps One through Five described on the following pages (in the exact order indicated) within the following framework.*

*The Paganos' attorney drafted a CRT which will pay them eight percent of the value of the trust assets each year for the rest of their joint lives. In the first year, the CRT will pay them $240,000 ($3 million x eight percent). Thereafter they receive eight percent of the trust assets (principal and income) each year. Thus, if the investment growth is ten percent in the first year, the "extra" two percent (or $60,000) is added to the original principal of $3 million. In the second year then, the Paganos will receive $244,800 ($3,060,000 x eight percent). Notice that the Paganos' right to distributions is limited to the original designated percentage and can never vary. For example, if they need an extra $150,000 for any reason, they can't look to the CRT to provide it.*

*Once Len and Sharon, the designated beneficiaries, have died, the balance remaining in the CRT must be distributed to a charity; it cannot pass to the Paganos' daughter (unless she is also named as a successor beneficiary in the Trust document).*

*From a tax standpoint, the Paganos pay ordinary income taxes on the income received from the CRT to the extent the trust earned income to "cover" the payout, and then they pay capital gains taxes on the balance.*

*After Len and Sharon have both died, the remaining principal will be distributed to a charity they have selected, either through the trust instrument or through specific designation in their wills.*

*It bears repeating that the CRT is an irrevocable trust; once signed, it cannot be changed. The payout rate, the trustees, the length of the payout rate, the beneficiaries—none can be changed (except for the ultimate charitable beneficiary designated in the will).*

## STEP ONE

**Creation of a Charitable Remainder Unitrust (CRT) document.** Based on the Paganos' wishes, their attorney drafts the document which, as stated above, is an **irrevocable** trust which specifies: (i) a payout or annuity rate to (ii) designated individuals (usually the owner and spouse) (iii) and names a charity or group of charities as the ultimate beneficiary. The actual design must incorporate all of the analysis contained in Steps Two through Five.

## STEP TWO

**Transfer of the stock to the CRT.** Transferring stock to a CRT *creates a charitable income tax deduction* because the value of the stock will eventually pass to a charity after an intervening period of time (e.g., Len and Sharon's lifetimes). The amount of the charitable deduction is not the value of the stock when contributed. Instead, the deduction is computed by subtracting the present value of the intervening time period (in this case Len and Sharon's joint life expectancy) from the original value of the contributed stock. The difference is the current charitable deduction, which is taken in the year the stock is contributed to the CRT. The present value of the intervening time period is affected by the payout rate (in this case eight percent) and the expected duration of the intervening time period. The higher the payout rate, the lower the charitable deduction. The longer the expected duration, the lower the charitable deduction. IRS tables are used to compute life expectancies and the resulting charitable deduction dollar amount. In Len and Sharon's case, the charitable deduction based on a $3 million contribution, their life expectancies (both age 55), and on an eight percent payout is $321,000.

## STEP THREE

**The CRT's Trustee enters into a legally binding agreement to sell the stock.** If Len and Sharon have previously entered into a legally binding agreement to sell the AFC stock, the CRT concept will backfire. Therefore, **it is essential that no binding agreement to sell the stock exists before it is contributed to the CRT.** What constitutes a "legally binding agreement" is, to say the least, a murky area of the tax law and each transaction must be evaluated on its particular facts by your tax counsel.

*CAVEAT:*
*If you have any interest in using a CRT to defray taxes, consult legal counsel before entering into any type of agreement, even a preliminary "non-binding letter of intent."*

## STEP FOUR

**The stock sale is negotiated by the CRT Trustee and the stock is sold to a third party.** *There are no taxes on this sale.* Consequently the CRT has the entire $3 million to invest.

## STEP FIVE

**The owners, as Trustees, invest the proceeds**—usually in a variety of stocks, bonds, and mutual funds. The investment goal of the CRT is to match the payout rate of eight percent. Whether or not that goal is met, the Paganos know with certainty they will receive eight percent of the trust value annually (paid quarterly) as long as either one lives.

Now that's financial security.

The downside is that a CRT's investments are generally restricted to publicly traded stock, bonds, annuities, and the like. CRT funds are not available to invest in a new business, for example, or to purchase an investment property.

The AFC case study illustrates three major advantages and three disadvantages of using a CRT to avoid taxes upon a sale of stock.

ADVANTAGES:

1. Avoidance or deferral of capital gains and consequently an increase in investment return of as much as 50 percent.
2. Creation of an income tax deduction.
3. Avoidance of estate taxes.

DISADVANTAGES:

1. Distributions from the CRT are limited to the original designated payout rate.
2. Trust investments must be in publicly traded securities, not in new business ventures.
3. Children receive nothing from business assets after parents die.

## WILL A CRT WORK FOR YOU?

I suggest you work through the following series of questions to determine if a CRT should play a role in your Exit Plan.

**1. Will you lack sufficient cash, after the business is sold, and after all taxes are paid, to meet your financial objectives?**

If so, using a CRT can result in as much as a *50 percent increase* in sale proceeds available to invest after the sale. Remember the Pagano example: without a CRT, they would receive $2 million after paying capital gains tax on the sale price. With a CRT, they can use the entire $3 million as investment capital—that's 50 percent more!

Keep in mind, the *after tax* proceeds must be sufficient to generate your desired annual income stream. Parenthetically, the first step in Exit Planning is, and always must be, the careful identification of your exit goals; particularly your financial objectives—i.e., how much money do you want, on an annual cash flow basis, for your needs? From the answer to this question, you can calculate how much capital you must have—"capital" that will likely be primarily composed of the after tax proceeds from the sale of your business.

**2. Do you have a low basis in your ownership interest?**

If you answer "Yes" to this question, a CRT may be an appropriate tax avoidance vehicle. Remember that the CRT saves the capital gains tax only on the difference between your basis in the company's stock and the sale price. For example, if the Paganos' basis in their stock had been $2 million, the use of the CRT would save taxes only on a gain of $1 million ($3 million sale price minus $2 million basis), resulting in a tax savings of "only" $330,000.

**3. Do you expect to invest the sale proceeds to provide retirement income?**

If yes, the CRT can be an excellent place to permanently park your money. The investments are not taxed as they earn money inside the CRT, taxation occurs only when distributed from the CRT. But access to the principal—the sale proceeds—is limited to the predefined annuity payout rate. That is all that is available from the Trust, regardless of actual need. For this reason, we often design the sale transaction so that the seller places *only a portion* of his overall ownership in the Trust before proceeding with the sale process. For example, had the Paganos wanted more access to capital after they sold their business, they could have placed 45 percent (or some other portion) of the stock in a CRT. This would give them free use of the 55 percent of the sale proceeds which remained outside the CRT. Of course, the Paganos will pay the capital gains tax on that portion outside the CRT at the time of sale (although the charitable income tax deduction attributed to the stock placed in the CRT will help offset some of this gain!).

**4. Are you comfortable with a fixed return predetermined annually?**

This question drives at the same point as question three: will you really be satisfied if your use of sale proceeds is limited, at least in part, to a fixed return? My experience is that most "retired" owners live on what their investments earn; they are unwilling to consume principal—the original net sale proceeds—for lifestyle needs. The payout structure of a CRT is therefore an acceptable one for most retiring owners. But you may not be a typical owner. Again, as described in the previous question, you may wish to sell only a portion of the business via a CRT in order to provide some unencumbered cash for

emergency, health, travel and slush fund purposes.

**5. Are you prepared to leave the entire CRT principal to a charity, rather than to your children?**

Upon the death of Len and Sharon Pagano, all assets remaining in the CRT are distributed to the charity they selected. That charity can be a private foundation, established by them and managed and controlled by their children. It bears repeating, however, that *all of the money* remaining in the Trust will eventually go to charity and not to the children.

For many owners, this is not a major concern for a number of reasons. First, the children have already received sufficient monies through lifetime gifting. Second, the balance of the estate that the children do receive may be sufficient. Third, to the extent the owners/parents wish to provide additional death benefit, they create a "Wealth Replacement Trust," funded with survivorship life insurance. Fourth, the CRT can provide that the children are successor lifetime beneficiaries to the owner and his or her spouse.

The first two scenarios mentioned above are feasible once it is determined that children will inherit an adequate amount of non-CRT assets. The third scenario requires some explanation for it is a common design (and certain to be suggested by your insurance advisor). Let's look at the Paganos again. Suppose Len and Sharon wanted their only child, Michelle, to receive what she would have gotten had the Paganos not decided to use a CRT. The net sale proceeds would have been $2 million (because $1 million of the $3 million sale price goes to pay the capital gains tax). Assuming no growth in the Paganos' estate, their daughter could expect to receive (after a 50 percent estate tax) approximately $1 million of the $2 million taxable estate. The Paganos determined that they needed to leave their daughter $1 million net of all taxes in order to replace the $3 million.

The easiest way to replace this "lost" $1 million of wealth is to acquire $1 million of survivorship or "second to die" life insurance. To prevent the insurance proceeds from being included in their estates, Len and Sharon created an Irrevocable Life Insurance Trust (ILIT) to acquire and own the second to die policy, with Michelle as the beneficiary, and perhaps even as the Trustee. The ILIT can be designed to provide lifetime benefits to Michelle, and then to pass, tax free, the remaining trust assets to Michelle's children (thus enabling another generation to dodge the estate tax bullet).

I dwell on this technique because it is frequently used, is quite cost efficient, and is an intelligent use of life insurance. The premiums for this type of survivorship contract are surprisingly low—approximately 60 percent of a single-life contract. The reason for this cost efficiency is apparent: The insurance company doesn't have to fork over the death proceeds until *both* insureds die. For example, the annual premium (per million dollars of coverage) for the Paganos, both age 55 and in good health, was approximately $18,500 based on a ten year payment plan, at which time premiums are expected to vanish.

The fourth method used to mitigate the inheritance "loss" to a child is to make her a successor beneficiary to the original beneficiaries (in our example, Len and Sharon). After Len and Sharon die, their child steps into their shoes and begins receiving the payout distributions. The disadvantage to this technique is twofold. As parents, when the Paganos initially fund the trust, they make a gift to Michelle of the net present value of her right to receive the income beginning *after* Len and Sharon's life expectancies are determined to have ended (using the IRS's actuarial tables). A taxable gift is deemed made in that amount when the trust is funded, even though the child may not (and hopefully will not!) enjoy the income stream for many years. The second disadvantage is related to the first—the charitable income tax deduction will just about disappear since there will be a much younger life between the Paganos and the right of the charity to finally receive its remainder interest. Nevertheless, in some situations this is a simple and effective means of passing family wealth to a younger generation.

**6. Is your business a regular or "C" corporation?**

If yes, there are no undue tax consequences upon the transfer of the stock into the CRT. If you have a "C" corporation and expect the buyer to insist on an asset sale (as is usually, but certainly not always, the case), can a CRT help? Indeed it can. Assume the sale of the Paganos' business was an asset sale resulting in sale proceeds of $3 million. AFC, as a "C" corporation, will pay a corporate income tax on the $3 million of approximately $900,000.

How will the owners then get the $2.1 million out of the now inactive corporation without paying a second tax? The IRS will certainly treat any significant distribution to the owners as a non-deductible dividend, thus reaping another $700,000 or so in taxes. The net result is $1.4 million to the Paganos out of an original $3 million cash sale. Using a CRT eliminates the second tax because the AFC stock will be liquidated and the company dissolved after its transfer into the CRT. The mechanics of this can be tricky, so be sure to use experienced advisors as you begin planning and implementing this technique.

If, however, your company is a Subchapter S corporation, the transfer of the stock to a CRT is a **disqualifying event** and will cause your company to lose its Subchapter S status. Take great care and caution if considering the transfer of such stock to a CRT and the subsequent loss of Subchapter S status. Usually, it is advantageous, from a tax standpoint, to be an "S" corporation when selling a business. The reason: most buyers want to buy assets, not stock in order to (1) avoid existing corporate liabilities and (2) apply a major part of the sale price to the asset purchase in order to step-up the depreciated basis of those assets for re-depreciation purposes. Therefore, if you intentionally revoke the "S" election, you'd better be darn sure you have a stock sale. And since you can't have a binding agreement to sell a company in advance of transferring the stock into the CRT, you are mired in the proverbial "Catch 22."

**7. Is the anticipated sale a stock sale?**

As seen above, if the anticipated sale is a sale of stock, or even a sale of assets from a "C" corporation followed by a distribution of money from the corporation to you, a CRT may be appropriate. A CRT is not recommended for a sale of assets from an "S" corporation, partnership, LLC or sole proprietorship.

**8. Is a current charitable income deduction useful?**

Of course it is. In fact, the deduction may be particularly useful in the year of sale because it can offset gain from the sale of the business that otherwise pushes you into a higher tax bracket. If you don't have sufficient income to use the available income tax deduction, you can carry the charitable deductions forward for five years.

BONUS QUESTION: **Do you wish to leave money to one or more charities?**

I've found that most business owners are not particularly motivated by the thought of leaving money to charity. Once the business is sold, however, and owners have a substantial amount of liquidity, thoughts do turn to charitable endeavors. That is why this question may become more important long after you've sold the business.

## CONCLUSION

Believe it or not, the above discussion barely touches upon the subject of Charitable Remainder Trusts. Space does not permit discussion of the many design features that serve to increase the flexibility of this most valuable tax avoidance technique.

Using a CRT gives business owners the opportunity to be charitable to their families, to themselves and to their favorite charities; in fact, to everyone but the Internal Revenue Service.

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