

Transfer a family business in a tax-smart way

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Is a family-owned business your primary source of wealth? If so, it's critical to plan carefully for the transition of ownership from one generation to the next. The best approach depends on your particular circumstances.

If your net worth is well within the estate tax exemption, you might focus on reducing income taxes. But if you expect your estate to be significantly larger than the exemption amount, estate tax reduction may be a bigger concern.

IDGT

An intentionally defective grantor trust ("IDGT") is an *income* defective trust. As such, it can be an effective tool for transferring business interests at a minimal gift and estate tax cost.

An IDGT is designed so that contributions are completed gifts, removing the trust assets and all future appreciation in their value from your taxable estate. At the same time, it's "defective" for income tax purposes; that is, it's treated as a "grantor trust" whose income is taxable to you. This allows trust assets to grow without being eroded by income taxes, thus leaving a greater amount of wealth for your children or other beneficiaries.

The downside of an IDGT is that, when your beneficiaries inherit the business, they'll also inherit *your* tax basis, which may trigger a substantial capital gains tax liability if they sell the business. This result may be acceptable if the estate tax savings outweigh the income tax cost. But what if the value of your business and other assets is less than the current estate tax exemption amount, so that estate taxes aren't an issue? In this case, you might consider an *estate* defective trust.

Estate defective trust

An estate defective trust is designed so that beneficiaries are the owners for income tax purposes, while the assets remain in the estate for estate tax purposes. Assuming your beneficiaries are in a lower tax bracket, this strategy will result in lower "familywide" taxes. And, because the trust assets remain in your estate, the beneficiaries' basis in the assets is "stepped up" to fair market value, reducing or eliminating their potential capital gains tax liability.

Please work with us to determine the right strategy to implement when transferring ownership of your business to your heirs.

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