Mary Vandenack provides the transcript from Legal Visionaries podcast on Consider a Business Owner Trust for your Sale.

TRANSCRIPT:

Mary: On today's episode, my guest is David Murray. Dave is Vice President of Sterling Foundation Management, LLC based in Reston, Virginia. Sterling manages family initiated charitable entities including private foundations, operating foundations, public charities, supporting organizations, and operates a donor-advised fund in addition to providing philanthropic advisory services. Sterling also provides secondary planning services for existing split interest charitable trusts, including charitable remainder trusts and charitable lead trusts, and offers tax exempt trust planning services for clients with appreciated real estate, concentrated positions and business interests. Sterling does not manage your custody assets and does not provide tax, legal or investment advice.

Dave has over two decades of experience in charitable planning, works extensively with trust and estate attorneys, accountants and financial advisors, is a bachelor and graduate degrees in engineering and MBA and is married with two kids. I asked Dave to participate in this episode as well as we're actually doing a series of five on selling business interests, and today particularly is selling a business interest using a business owner trust, but we are doing a series of episodes discussing these types of trusts for different types of uses. Dave, I really appreciate you joining me again today.

Dave: Mary, thank you so much. It's so fun to be with you again. I'm very excited to be here. This podcast is intended to help anyone with a business interest who is thinking about selling it. Those who are looking to sell their business interests are likely aware of the more popular options available to them, including an outright sale, a tax-free merger, an installment sale. Any of these options can make a lot of sense depending on the situation.

I'm going to talk about another option that I will bet many business owners have not considered. The first podcast in this series entitled Selling Appreciated Assets Using Tax Exempt Trusts Under Internal Revenue Code Section 664 provides a deep dive into the fundamentals of what we we're calling and what we're going to talk about today, a business owner's trust. If any listeners would like more information about the use of these trusts, I encourage you to check out this podcast.

So the structure of today's podcast, Mary, is we're going to provide details on the trust, talk about how it can be used in conjunction with the sale of the business interest, and then provide some client illustrations. Should be a great time!

Mary: So, let's just start by talking about, tell us what is a business owner trust?

Dave: Okay, so it is a specially designed trust that we've named to help those who wish to sell a business interest. Quite simply, it is a trust established by someone with a business interest for the purpose of deferring capital gains tax on the sale of this interest. It allows a business owner to sell their business interest to set aside the assets within the trust for the benefit of themselves and their heirs. The trust assets are then managed and distributed according to the trust terms and conditions.

So the basic idea, Mary, is that in order to sell their business interest, a business owner gifts their business interest to a business owner trust, and the trust sells the business interest. Now, I should note, a business owner trust is a tax-exempt trust under section 664 of the Internal Revenue Code. And here's an interesting fact, Mary, section 664, which governs tax-exempt trust, more commonly referred to as charitable remainder trusts, has been around since 1969. So it's a very mature portion of the tax code. The fact that this type of trust is tax-exempt is important to emphasize.

So, what does this really mean? If you're a business owner what does this really mean? Well, when a business owner contributes to business interest to such a trust, the trust can then sell the asset immediately, and the trust is not required to pay tax on the sale proceeds. That's right, zero tax. Instead, the trust can then reinvest the entire sale proceeds into a diversified portfolio of stocks, bonds, mutual funds, ETFs, and other similar investments. Once the trust is funded, it can provide income to individuals who are named on the trust to receive income, and we call these individuals income beneficiaries. While such a trust does not pay tax when the business interest is sold, tax is required to be paid by the income beneficiaries when income is distributed to them by the trust.

It's important to note that if such a trust is designed properly, a business owner, after gifting their business interest to the trust, although they're entitled to receive income as income beneficiary from the trust, they can instead defer taking income. They're not required to take income, thus allowing them to keep their taxable income to a minimum if they don't need the cash.

Anyone contributing property to a business owner trust will generally receive a tax deduction for at least, Mary, 10% of the value of the assets contributed. The way these trusts work is that the shorter the expected duration of the trust, the higher the upfront deduction. And correspondingly or conversely, the longer the expected duration of the trust, the smaller the deduction. Now, the expected duration of the trust is dependent on the number and age of the income beneficiaries. Typically, a business owner trust is drafted such that the owners of the business interest, oftentimes it's mom and dad, are the first-generation income beneficiaries and their children and grandchildren are named as successor generation two and generation three beneficiaries respectively. By naming, Mary, two or more generations of income beneficiaries on the trust, the expected duration of the trust will stand for, and get this, decades, in many cases for 50 even up to 60 years.

So, let's just look at a quick example. Clients Rick and Cindy own a business interest worth $20 million. If Rick and Cindy contributed the business interest to a properly structured business owner trust and the trust could immediately sell the business, recognizing the entire $20 million, the trust would owe no tax, and so it would have $20 million to invest in a diversified portfolio of assets. By creating and funding a business owner trust, Rick and Cindy would receive a minimum tax deduction of $2 million, or 10% of the value of their business interest, and they'd receive a legal right to an income stream of not less than 5% per year from the trust for a very long time and the time, the duration, would depend on the ages of themselves and their children and grandchildren at the time the trust is funded. And at the end of the life of the trust, the balance remaining in the trust can be used to establish a legacy for Rick and Cindy's family.

Mary: And so I just kind of want to emphasize that a big strategy, because that income tax deduction might be that 10% because you're designing it for the long term, but one of the keys is that you can put some assets, some appreciated assets of your business in there today, sell it, and you're not going to have the gain that you would otherwise have recognized, and then plus you get some deferral and some other benefits. But can you just talk a little bit about some of the other options that investors might consider when looking to sell a business interest?

Dave: Absolutely, Mary. So, we're not experts on these other options, but they're very commonly known amongst business owners. We work with business owners, and we are aware that they're investigating these options when they consider the sale of their business as well. First is an outright sale, just selling your business for cash. It's the easiest approach, but let's face it, not many people want to pay the taxes. If they were to sell their business outright, you're taking a big tax hit on the sale. So, it's oftentimes not something that is seen as being desirable.

A tax-free merger is another option. It allows a seller to receive some of the sale proceeds in cash or entirely in stock of the acquiring company without paying any tax. We typically would see this with public companies using their shares to acquire other companies, Mary. But I want to make a note here that's important because even if a business owner does a tax-free exchange, in other words, they're going to receive shares in the acquiring company and paying no tax, at some point that family is going to likely want to diversify away from those shares. We think of this more as a concentrated position, but a business owner’s trust would be suitable down the road should they wish to diversify away from those shares of the acquiring company. I just want to make that special note because it is important. These options aren't necessarily mutually exclusive, Mary.

The final option, the one that we know is used fairly frequently, is an installment sale. It's really the sale of a business for combination of cash and a note. And the main benefit of selling an eligible business by an installment sale is the spread of the realization for tax purposes of the gain over several years, which can reduce taxes paid. But the main drawback of an installment sale, as you know Mary, is that you don't get the full sale amount upfront, you have to wait and receive the payments over time. So sometimes this is not desirable.

Mary: And it partly depends on is your security your interest in the business that you just sold? And you have some significant risk with that installment sell as well. So, I sell my business, my interest, I don't really want the business back, the owner runs it to the ground, I get the business back. So, the installment sale works really well in some situations, but not all. Well, let's say that an owner wishing to sell a business interest has looked at selling outright, does not like the idea of paying so much tax, so they've thought about an installment sale. Why should they consider a business owner trust?

Dave: It's a great question. Ultimately, the option they choose will depend on the business owner and their unique situation. We would encourage anyone looking to sell a business just to review all the available options with trusted advisors. I think it's most important to focus on the goals of the business owner. What do they wish to accomplish? Is tax deferral important? I would say a key reason a business owner may choose a business owner trust in conjunction with the sale of their business interest is tax deferral. As I've already noted, when the trust sells a business interest, no tax is paid by the trust. The best way to think of this benefit is that because the trust is not paying tax, Mary, the tax that would've been paid by the owner had they sold it outright, that stays in the trust and gets reinvested and gets to grow and compound into the future and will ultimately serve to benefit the family financially down the road, both for the parents, the business owners, their children, and their grandchildren. So tax deferral is one reason, Mary, probably the key reason why a business owner who's looking to sell their business interest should consider one of these trusts, that ability to not pay tax state, to basically defer tax on the sale into the future.

Another important consideration, Mary, is this desire to have your children and grandchildren ultimately receive income. A business owner trust can be structured so that after the original contributor and their spouse, think of these as the business owners, after they pass away, the contributor's children can receive the income. In some cases, even the contributor's grandchildren. It all depends on everyone's ages when the trust is created and funded. There's no stated maximum possible term for a trust, but the expected life of most business owner trusts would be in the range of 50 to 60 years.

The next thing that I think someone should think about, Mary, when they're contemplating use of one of these trusts is the ability to defer income. A properly constructed and properly managed business owner trust can provide a period of tax-free deferral during which no payments are made to the beneficiaries, and instead, the assets grow inside the trust tax-free. When this deferral is in place, Mary, the trustee maintains a bookkeeping account called an accumulation account. Each year while deferral is occurring, the amount that would've been eligible to be paid but wasn’t added to the accumulation account. So let's use an example, because the trust accounting gets rather complicated, but let's use an example that will help clarify this. So again, the principal is the business interest has been gifted to a trust, the trust has sold the business interest, the family has access to income from the trust, but they don't have to take the income, they can defer the income. So, we use Rick and Cindy's trust as an example. It has a value of $20 million and a payout of 5%. So, it could pay Rick and Cindy a million dollars a year. But if Rick and Cindy have decided they do not want to take the income for a period of time, let's say five years, just as an illustration, after five years, there would be $5 million of deferred income available in the trust. At that time, after five years, if no further deferral was desired, Rick could take all or a portion of the $5 million. And so, the ability to defer income just gives the family lots of control managing their taxable income.

And finally, I just wanted to note, Mary, because this is not often contemplated when someone is looking to sell their business, but asset protection. If asset protection is important to the business owner when they're selling their business, they may want to think about a business owner trust. In addition to the tax and income benefits of a business owner trust, because it is a trust, it can include a spend thrift clause under which certain circumstances will protect the trust assets from any claims that might be brought against the trust income beneficiaries.

Mary: So, I personally think asset production should be part of any discussion of any trust, but I know that it doesn't always come up. Are there any disadvantages of the business owner trust?

Dave: There are, there are. Access to principal is a key disadvantage of a business owner trust. So once the trust is in place and the business interest has been gifted to the trust and the trust has sold the business interest, the business owner is now limited to income provided by the trust. Also, there are prohibited transactions to consider. Income beneficiaries of a business owner trust must be mindful of regulations regarding self-dealing, specifically they cannot borrow money from the trust and they cannot buy or sell assets from or to the trust. And I should note, Mary, an operating business should not be owned by the trust as this will result in unrelated business taxable income. So, I want to emphasize that a business interest should only be gifted to a trust, a business owner trust if the business interest is to be sold. It should not be gifted to the trust and be retained by the trust.

Mary: So the concepts are somewhat complicated and so I'm hoping you could maybe use a specific client illustration.

Dave: Well, let's do that. So, before we talk about client illustrations, I would just want to talk about the timing issues because we've seen unfortunately far too many times, Mary, where a business owner has come to us, there's already a legal commitment in place for them to sell their business and unfortunately, it's too late for us to be helpful with one of these trusts. So, I want to emphasize that, Mary, if someone is looking to use a business owner trust to sell their business interest, there cannot be a legal commitment to sell. It has to be a situation where maybe they've talked to prospective buyers, but there's no legal obligation to sell in place. So be proactive. You should contemplate this kind of trust planning, I would say months in advance of any actual sale of your business interest, okay?

Now you asked a great question, let's talk about some clients we've worked with that have utilized the business owner trust. Brian and Barbara are a couple in California we worked with recently. This is a young couple, Brian is 55 and Barbara's 54, and they have teenage children, the same age as my children actually, 14 and 17. They live in California. They invested $7 million in their business 10 years ago, and Brian and Barbara own 100% of the company, which is now valued at $70 million. They were approached by a prospective purchaser some months ago who wanted to purchase their business for cash. Now, if Brian and Barbara were to sell this business outright, if they just sold it outright, they would've paid significant tax, over $60 million of gain in the business, of course, they're California residents. And it was important to Brian and Barbara that in selling the business, they could defer capital gains tax on the sale, this would be over $20 million. If they didn't defer the tax, they would end up paying $20 million. So basically wanted to defer tax on the sale and secure passive income for themselves for the rest of their lives and secure some income for their children for as long as possible into the future. And given that Brian and Barbara had other sources of income, they told us it was important that they'd be able to defer income really from their trust for a period of up to 10 years and then start taking income from the trust. So, in architecting the trust, Mary, we first looked at Brian and Barbara's joint life expectancies, which turned out to be 40 years, given that they're still in their mid-fifties, they're quite young. And then we looked at the maximum duration their two children could be added to the trust as successor income beneficiaries, and given their ages, again, 14 and 17, they could be added for a 15-year term. So Mary, the way this trust was set up, and the trust is now in place and running, it's projected to pay Brian and Barbara income for 40 years and their children for 15 years so that's a total expected trust duration of 55 years.

The trust was created to allow Brian and Barbara to collect income at 5% a year for the rest of their lives and then their children the same 5% once Brian and Barbara were no longer living for a term of 15 years. This structure resulted in Brian and Barbara realizing an upfront tax deduction of approximately 10% of the value of their gift to the trust, which is about $7 million. With the trust up and running, their business interest has been sold and the trust holds a diversified portfolio of securities. Brian and Barbara are not taking any income from the trust and don't plan to for the next nine or so years as they rely on other sources of income. Use of a business owner trust will allow Brian and Barbara and their children more than double the income they'd receive if they were to have sold the business and paid tax and reinvested the proceeds.

So there's a great illustration, Mary, of one couple that we were able to help with the business owner trust. I have one more example, would you like to hear that as well?

Mary: I would.

Dave: Okay. So this is Anthony and Debbie, and they happen to be Californians as well, that's a matter of coincidence more than anything. They're a little bit older. So, Andy's in his mid-sixties and his wife Debbie's in her late fifties. They have four children in their mid to late twenties and early thirties, no grandchildren. Now they have a 50% interest in a retail business. Anthony and his business partner started the company about 15 years ago with minimal capital. So, Anthony's basis in the company is very low. We got a phone call, they were approached by a prospective purchaser who wanted to pay cash, and this was a fairly time sensitive situation. The prospective purchaser was not going to offer it shares, this was their preference, but that was unavailable to them.

So if they sold their business interest for $25 million outright, they would've to pay a significant tax, of course. As the buyer had expressed interest, but there was no legal commitment to sell in place, Anthony and Debbie were at liberty and free to consider use of a business owner trust. Again, there cannot be a legal commitment in place to sell before you create and fund the trust with the business interest. So, this sale was an opportunity for Anthony and Debbie to retire so it was important to them that in selling the business, they were able to defer the capital gains tax on the sale of their business interest, have income so they could travel, have an active retirement and provide income to their children once they were no longer living.

So by creating and funding of business owner trust, Anthony and Debbie were able to receive an upfront tax deduction of about $2.5 million dollars, which is about 11% of the value of their business being gifted to the trust. And of course, the trust paid no tax when the business was sold. Anthony and Debbie are entitled to take 5% of the value of the trust as income each year for the rest of their lives, turns out they don't need all of this money to live on so they're expecting to only take a portion of this income and defer the rest into the future. So, Anthony and Debbie, Mary, have a joint life expectancy of almost 33 years so they can expect to receive income from the trust for this period of time. And once they're no longer living, their children will be entitled to take income from the trust as successor income beneficiaries for a term of 20 years. So, the expected duration of the duration of this trust is 53 years. So, Anthony and Debbie loved all of this. They could defer income; they could get income for themselves and their children for a period of up to 53 years. But they also liked the fact that the end of life of the trust, again in 53 years, whatever funds remain in the trust would go into a donor-advised fund to create a legacy for their family and benefit their community.

Mary: Those are a couple really great examples that I think illustrate the concept. Do you have any last thoughts today?

Dave: Well, Mary, I would say anyone considering selling their business interest should evaluate all their options. The business owner trust is simply one option, and as I've stated, it's always a good idea to be proactive in planning the sale of a business interest. If a business owner wishes to sell their business outright and wants to defer tax on the sale of their business while receiving an upfront deduction and does not mind trading access to principal for the right of their family to collect income for decades, I will say, Mary, a business owner trust should be considered. We are more than happy to provide a no cost, no obligation analysis to illustrate how a business owner trust could be beneficial. And I'll pass it back to you with that, Mary.

Mary: Well, thanks. And we're going to include contact information for you with the release of this episode. So, if somebody wants to reach out to you, they can. As we reach the end of our episode today, I want to thank our sponsors, Interactive Legal, Veterans Victory Housing, Carson Private Client and Foster Group. That's all for now. Thanks for listening to today's episode and stay tuned for our future releases.