Generation to generation

Strategies enable breeders to pass on their Thoroughbred businesses while limiting their tax liability

by Neal Hayias, CLU, ChFC

TOM AND HIS WIFE, Barbara, started a small, family-owned Thoroughbred breeding business 20 years ago. In those years, they produced several graded stakes winners, and the value of their Thoroughbred business grew to $10-million, or roughly half their total assets.

Now 55, Tom is ready to reduce his role in the breeding business. His children have been involved in the business's day-to-day operations for many years and have contributed substantially to its growth and success. Tom's challenge now is to establish a plan that will allow the business to pass to his children upon his death or retirement without ruinous tax burdens.

For Tom and other breeders, a Thoroughbred business probably is their most valuable asset, and it is probably their most illiquid asset. Without proper planning, the owner's death in all likelihood would trigger substantial estate taxes, and sufficient cash may not be available to pay the taxes when due. In such a situation, the heirs might be forced to sell the breeding business and other assets to pay the estate taxes.

Fortunately for all owners of closely held businesses and especially such breeding operations as Tom's, strategies for passing along valuable enterprises from one generation to another are available.

One of the most common strategies is to create a trust, which is a formal arrangement that allows individuals to transfer legal title of certain assets to another party, known as a trustee. The trustee holds and manages the assets of the trust on behalf of the trust's beneficiaries. Certain trusts can help to mitigate taxes and protect heirs and the business from estate tax burdens.

Katey Barrett photo

VALUABLE ASSET
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Living trusts

A living trust allows the business owner to transfer assets into a trust and to retain control of the assets by naming himself or herself as the trustee. At death, a co-trustee or successor trustee can manage the trust's affairs and distribute the assets according to the terms of the trust.

The major advantage of a living trust is that it avoids putting an estate through probate court. Probate is an expensive, time-consuming process, and details of the estate are reported in legal newspapers to allow creditors and heirs to make legitimate claims. Particularly when an estate has no outstanding creditors, probate represents a significant loss of privacy that many business owners are eager to avoid.

Irrevocable life insurance trusts

Many individuals and business owners purchase large life insurance policies to help with payment of estate taxes upon their death. However, life insurance proceeds typically are considered part of a person's estate, thus boosting estate taxes even further.

One strategy for not making the insurance proceeds a part of the estate is an irrevocable life insurance trust. This type of trust is a separate legal entity that is created with the help of a lawyer. The trust owns and is the beneficiary of the life insurance. At death, proceeds from the insurance policy can be used to pay part or all of the estate taxes.

To prevent the proceeds from being included in your estate, all ownership rights must be assigned to the trustee, meaning the business owner loses the right to change the beneficiary or cancel the policy. To keep the trust at arm's length, the person who created the irrevocable trust would not actually pay the premiums. Instead, that individual would make gifts to the trust, and those gifts then would pay the premiums on the policy.

The person creating the irrevocable trust of course wants to make certain the insurance proceeds are used to pay estate taxes and the trust is treated as a separate legal entity for estate tax purposes. The method primarily used to achieve these goals is to arrange for the trust to receive something of value from the estate in exchange for the estate receiving the insurance proceeds.

For example, the trustee can purchase assets from the estate at fair market value, thereby providing cash to the estate to pay the Internal Revenue Service. The property sold to the irrevocable life insurance trust then could be retained and managed by the trust or distributed to beneficiaries.

As its name implies, the trust is irrevocable and essentially permanent; keeping the ability to alter or revoke the trust will lead to the life insurance proceeds being made a part of the estate. However, expertly drafted life insurance trusts can create escape hatches that give the trustee some room to maneuver when situations change.

Charitable remainder trusts

Charitably inclined individuals might want to earmark a sizable chunk of their estates to a charity, religious institution, or some other charitable beneficiary upon their death. With the help of a lawyer, one can create a charitable remainder trust into which earmarked assets can be deposited as a gift. That individual may then direct the trustee to pay him or her and perhaps a surviving spouse any income from those assets for life. After death or that of a surviving spouse, the charity would receive the remaining funds.

A charitable remainder trust can provide especially meaningful financial and tax benefits to a Thoroughbred breeder. First, the amount of the charitable donation is deductible for federal income tax purposes (normally up to 30% of adjusted gross income).

Second, the money provided as gifts to the charitable remainder trust is no longer part of the taxable estate and thus is not subject to federal estate taxes. Finally, the trust can sell the property placed into the trust (such as stocks or other assets) without paying capital gains taxes on any prior or future gain.

While the charitable remainder trust can reduce estate taxes by taking the charitable gift out of the estate, the principal goes to the charity and not the heirs.

If sufficient additional assets are not available to protect the heir's stake in the business, one option is to purchase life insurance equal to the assets in the trust or equal to the amount the children would lose, after estate taxes, if they had inherited the trust property. The trust is generating an income flow that could be used to pay the premiums.

In sum, a charitable remainder trust is an option for individuals who want to:

- Sell highly appreciated assets without paying capital gains taxes;
- Increase annual income from those assets by having the trust reinvest them for higher returns;
- Receive a current income tax deduction for the present value of the future interest in the trust that goes to charity;
- Save estate taxes by reducing the taxable estate; and
- Benefit a charity or charities at death.

A business gift

All the strategies described above can help mitigate either probate costs or estate taxes, and in some cases they can even help to reduce income and capital gains taxes. However, many breeders find that the most attractive alternative is to give the business to their heirs during their lifetimes.

Under current tax law, individuals can make tax-free gifts of up to $10,000 per child per year and $20,000 if they are married and their spouse joins in making the gift. In 2002, these amounts increase to $11,000 and $22,000, respectively. In cases of privately held companies, gifts of minority interests in a private business can be discounted—that is, larger amounts can be given and still fall within the tax-free limits.

Even when the gifts must be sufficiently large that they trigger gift taxes, this strategy almost always is preferable to just allowing the business to pass into an estate and thus to the heirs. Although the gift tax and the estate tax are currently levied at the same rate, the amount of money that goes to the government can potentially be smaller if the business owner makes gifts and then pays the ensuing gift tax.

For example, let us assume that Tom wants to transfer his $10-million breeding business to his children. Under the new tax law, gifts and estates exceeding $1-million are subject to a maximum 50% tax next year.

If Tom makes a $10-million gift, he will owe $5-million in gift tax. Total cost of the gift and the tax is $15-million if he transfers the business in one transaction rather than over a number of years.

Here is the difference: Gifts are tax-exclusive, which means that the children get the business and the gift tax has been paid. No other taxes are due, and Tom and Barbara are left with $5-million in their estate.

Estates are tax-inclusive, which means that they pay tax not only on the capital assets but also on money that will be used to pay the estate taxes. If Tom and Barbara died in 2002, the $20-million estate would be subject to a $10-million estate tax. Thus, assets other than the business would need to be liquidated to pay the estate taxes, with no remainder.

Family limited partnership

Another alternative is the family limited partnership, which allows a business owner or other individual to transfer assets into a fund for the benefit of his or her children or any other beneficiary. As noted earlier, $11,000 (or $22,000 for a couple) can be given next year without incurring a gift tax, and this amount can be discounted for lack of marketability and control.

For example, Tom transfers $500,000 of his business into a family limited partnership in which three children and seven grandchildren are participating. Thus, in 2002, Tom can transfer at least $110,000 without gift taxes, and the discount can be as high as 40%. Because of the family limited partnership's flexibility, Tom can make this $500,000 gift to ten people over a three-year period and avoid gift tax.

A family limited partnership is also a good way to insure the life of the owner. In this case, the partnership buys the insurance and receives the proceeds.

For all its complexities, an efficient and professionally crafted estate plan is one of the most vital things a business owner can have. A good estate planner will help to determine what estate-planning techniques are best for you, your business, and your family. Because these decisions are so important, you should enlist the help of as many professionals as possible, including your accountant, attorney, and financial professional before making any decisions.

The contents of this column do not constitute legal or tax advice. Readers should consult their own advisers.

This article appeared in the December 22, 2001, issue of Thoroughbred Times. To subscribe, call 1-888-499-9090