Gift Your Company Stock: How to Use a GRAT

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(Published in Printing News magazine, August 14, 2006)

Because so many small printing companies are family owned and operated, it is important to understand how to easily pass on the business when the time comes. A Grantor Retained Annuity Test (GRAT) is an estate planning tool used to help transfer wealth to the next generation with little or no transfer tax cost.

A GRAT is an irrevocable trust funded with assets, preferably highly appreciable assets. The person contributing the assets is called the grantor. The trust pays the grantor periodic annuity payments for a term of year. These payments may be determined as a percentage of the trust assets or just a fixed amount with or without a predetermined increase. At the end of the term, the trust distributes the assets remaining to beneficiaries.

The benefit of a GRAT is its ability to shift future appreciation on assets to others with very little or no gift taxes. The goal is to have the assets transferred to the GRAT actually appreciate at a higher rate than the IRS prescribed rate of return. The difference between the actual return on the investments and the IRS assumed return would pass to the beneficiaries at the end of the GRAT term.

In succession planning, it is common for owners of small printing companies to transfer stock ownership directly to the next generation. This gift can trigger a tax when the value of the transfers exceeds the unified credit and statutory allowances. Because stock of a closely held printer can appreciate substantially over time, it is a good candidate for a GRAT.

Paying It Forward

For example, assume the sole owner of John Doe Printing Co. has a closely held business that was valued at $5 million. His son is second in command and functions as the vice president. The owner is 60 years old, and the son is 30 years old. The company is very profitable and has a strategic business plan to support doubling in revenues and profits over the next five years. As a

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result, it is fair to assume this business will substantially appreciate in value over time.

If the owner wanted to gift his stock to the son by making direct transfers during the next five years, he would be limited to the statutory annual exclusion amount — currently $12,0000 or $24,000 if married and consent to a joint gift, and $1million of unified credit or $2 million if married and consent to a joint gift. In doing so, the owner transfers $2.1 million of stock value to the son in the next five years; however, anything more than this will be costly in gift taxes.

This situation is suitable for a GRAT because the stock is an asset that appreciates in value and produces income from the business.

As a result, the owner can contribute the stock of the business into a five-year GRAT and receive monthly annuity payments equivalent to the profits of the business over the next five years. The annuity payments will represent a percentage of the discounted value of the assets contributed to the GRAT.

If the assets of the GRAT do not yield sufficient income to fund the annuity payments, principal of the trust will be distributed back to the grantor to satisfy the payments. At the end of the five-year period, the beneficiary will receive the remainder of the trust. By then the stock may be worth $10 million instead of $5 million.

The gift is considered complete when the GRAT is funded. Any taxable gift resulting from the transfer of property to the GRAT is the present value of the remainder interest, determined using a prescribed percentage from an IRS-assumed rate of return.

Not for Everyone

Under the facts of the example, a taxable gift would be minimal if there was a high annuity payout level, where the grantor receives back almost all of the trust assets. This means the grantor earns the assumed IRS investment return, and the gift tax is based on the anticipated remainder value of the GRAT at the end of the annuity period.

If the donor dies before the end of the annuity period, the trust assets will be included in the donor's estate, and the advantages of the GRAT strategy will be lost. Also, funding a GRAT with hard-to-value property, such as real estate, partnership interest, or shares of a closely held business, poses valuation challenges.

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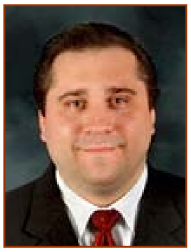

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