

USE OF TRUSTS DURING START-UP AND EARLY STAGES OF THE BUSINESS

A perusal of any recent seminar agenda serves as a reminder that valuation issues are an important part of sophisticated estate planning. Business structures such as FLPs and LLCs allow parents and grandparents to give interests in a business entity that are worth less than a corresponding interest in the underlying assets owned by the business entity. These structures thus allow clients to leverage their annual and lifetime gift tax exemptions and are discussed in the part of this program entitled “Navigating The Current FLP & LLC Waters.” As the title of that segment implies and as most estate planners are aware, the IRS aggressively challenges FLPs and LLCs. Are there any other ways to use valuation to leverage gifts?

The start-up phase of a business offers just such an opportunity. During these periods, the business owner’s family can take advantage of the business’s low value to make gifts of non-controlling interests to a trust for family members. These gifts can be made in a way that leaves our business owner, Samantha, in control of the business. This article will discuss two techniques to use this tool and will then discuss some issues that are common to the two variations on this technique.

I. Gift by Samantha’s Parents to Irrevocable GST Trust

A. The Basic Technique

Samantha may need assistance financing the software business in its early stages when banks and other traditional lenders are reluctant to make loans. Her parents, however, may be willing to provide that money. They can do so and receive some return on their investment through the following technique:

Her father can contribute up to \$1 million to an Irrevocable Trust. The Trustee will then use that contribution as start-up capital to form the business or, if the business has already been

formed, to purchase an interest in the software business. Because of the low value of the business at this point and the importance to Samantha that she control the business, the gift will probably be much smaller than this amount. Indeed, it may be possible for the gift to use less than the number of available annual exclusion gifts times the current \$11,000 limit on such gifts.

The trust terms will allow the Trustee to pay income to Samantha's mother during her lifetime. After her death, the Trustee can pay income to Samantha. After her death, the Trustee can pay income or make principal distributions to Samantha's children. Samantha's father will allocate his GST exemption to the gift to the Irrevocable Trust. The Trustee may also have discretion to distribute principal to family members at different stages of the trust's existence.

If the software business prospers, as it has in our example, and if Samantha's mother and father remain happily married during her father's lifetime, Samantha's father may indirectly benefit from the Trustee's discretion to distribute income to his wife. After the business is sold, the Trustee will be able to invest the proceeds for the growth and income needs of Samantha and her children. All of this will be accomplished with little or no use of her father's lifetime gift exemption.

B. Grantor Trust or Not

One factor to consider is whether to make the Irrevocable Trust a grantor trust during Samantha's father's lifetime. A grantor trust is simply one where the grantor retains one of the powers set out in IRC §§ 671 - 679 and thus pays any income tax resulting from the trust's income. Because some of these powers would result in estate inclusion, the grantor power must be selected carefully. The power either to "reacquire the trust corpus by substituting other property of an equivalent value," IRC § 675(4), or to borrow for less than adequate security or adequate interest, IRC § 675(2), will result in grantor trust status and is a commonly used tool to achieve that result and simultaneously avoid estate inclusion.

