

Business Valuation Notes

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Estate Tax Back to 35%? Think GRATs...

PLAN YOUR ESTATE

...Congress still looking for ways to tighten transfers

Estate planners in recent years have often used GRATs or Grantor Retained Annuity Trusts to transfer wealth for clients, potentially reducing estate tax liability at death.

However, the United States Administration and Congress continue to discuss possible limitations on family wealth transfers for tax purposes, and GRATs contain terms which may eliminate benefits even if rules are not changed.



Grundmeier

According to Joel Grundmeier, CPA, Olsen Thielen & Co., Ltd., low interest rates have made this a good time to set up a GRAT. He said that a drop in the IRS interest rate assumption to 1.8% makes this vehicle especially attractive beginning in December 2010.

In a presentation about estate planning, Grundmeier observed that there are many kinds of trusts and that GRATs offer some unique advantages to reduce wealth transfer taxes.

Grundmeier heads Olsen Thielen's estate tax department.

GRATs are effective vehicles to freeze capital appreciation and further reduce gift value by subtracting benefits which remain with the grantor.

"With a GRAT," Grundmeier said, "a person puts assets in a trust and receives an annuity, or annual income, for a set period in exchange. The value of the gift is value of the property placed in the GRAT less the present value of the retained annuity using the required federal rate under IRC 7520. As long as the assets appreciate by more than the required federal rate, any increase in value above this rate goes to the trust beneficiaries tax-free. In December, the required federal rate fell to 1.8%, an all-time low, making GRATs especially appealing.

"There is potential legislation to make GRATs less attractive that will limit GRATs to a minimum length of 10 years and disallow the use of zeroed out GRATs. Because of this, persons interested in setting up GRATs should do so as soon as possible. Shorter term GRATs are often advisable be-

M&A Transaction

Deal Making Slows

The Alliance of Mergers & Acquisitions Advisors® has announced that the closing rate of merger and acquisition transactions among private companies decreased in the second half of 2010, but pricing multiples held steady.

The information, assembled by a Deal Stats survey of AM&AA, is from results through June 30, 2010 compared to prior survey periods. AM&AA President Mike Adhikari, former affiliate of the Minnesota Business Valuation Group and current President of Illinois Corporate Investments, Inc. and Business ValueXpress, said, "The continuation of stable transaction multiples in this post-recession period is a positive trend."

According to survey results, the total value of transactions declined to \$961 million from \$1.25 billion in the second half of 2009 and \$1.36 billion during the prior 12 months ended June 30, 2009. Both M&A advisors and brokers reported a decrease in closing rates. Average and median transaction multiples were 5.26 in the first half of 2010 versus 5.22 in the second half of

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Estate Taxes

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cause the grantor must outlive the term of the GRAT to avoid including the property in the grantor's estate," Grundmeier added.

Recently President Obama's Administration and Republican leaders reached an agreement whereby estate taxes would be capped at 35%, instead of going back to 55%, cited as a conservative victory. For 2010 the rate actually declined to zero, but would have returned to 55% if dialogue stalemated and a consensus could not be attained.

Although many Democrats are angered about the agreement, the decisive conservative gains in the past election are likely to assure passage. Even though the top rate is now more certain, it is still high for those transferring wealth and other restrictive legislation continues likely with respect to individual methods now used by planners. One of those targets has been treatment of GRATs.

Randall Schostag, President, Minnesota Business Valuation Group, said that clients create GRATs using assets expected to earn more than the Internal Revenue Service's assumed standard return during the term the GRAT is in force and before the death of the grantor.

The IRS assumed rate of return is calculated using IRS Code 7520 interest rate assumptions, now at 1.8% as of Decem-

ber, down from 3.2%. "If the assets return more than that annual amount over the period of the trust, the surplus is passed at the earlier effective valuation date to the beneficiaries," Schostag said. "Thus we look at this as a kind of hurdle rate."

The trust is set up under IRS Code guidelines set forth in Section 2702.

In simple terms, the client transfers assets to an irrevocable trust for his or her beneficiaries for a defined time period. The assets are appraised at the time of the irrevocable transfer; the amount of the taxable gift or actuarial value is the fair market value of the assets minus the value of the client or grantor's retained annuity interest.

Because the annuity payments reduce the value of the gift by the amount of the annuity, the remaining gift can be quite small, Schostag explained, thus reducing the taxable estate. The gift tax is paid when the trust is established. If everything works according to plan, the assets received by the beneficiary at the termination of the trust are then transferred without more tax.

Schostag provided the following example: If a client gifted shares of common stock worth \$1,000,000 to an irrevocable trust with a time period of 10 years and the client was to receive payments from the trust of \$50,000 per year for each of the 10 years, those payments would be worth \$453,865 at the time of the gift, using the 1.8% IRS rate. This is the client's "retained interest". The balance of the

\$1,000,000 or \$546,135 is transferred to the beneficiary at the end or termination of the trust time period.

This means only about 55% of the value is charged a gift tax. Using this example, the right to receive \$50,000 for 10 years is worth \$453,865 and the right to receive the balance at the end of 10 years is worth \$546,135.

"It's important that the irrevocable trust is properly structured to fulfill Section 2702 so that it is a "qualified interest" or the grantor will not retain an interest and the full \$1,000,000 value will be considered the gift value. You should always retain qualified legal representation for your tax work. Neither MBVG or Olsen Thielen, MBVG's parent, are lawyers or practice law. Our comments are based solely on our exposure to client work," Schostag cautioned.

The clients for these vehicles are called annuitants and they face several possible risks. First, the annuity payment must be either a fixed amount, such as \$50,000 per year, or a fixed rate, such as 5%, of the starting value of the assets. Fixed payments may actually increase and, therefore, may be used to further reduce the retained gift value, but presently the change may not exceed 120% of the amount payable the prior year.

Note that if additional payments from the trust to the trustor are voluntary / not required to be made by the trust when it is established, (Continued on page 3 Estate Taxes)

Estate Taxes

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those payments cannot be used to offset the remainder value for the beneficiary's gift. And once implemented, the grantor is not able to add funds to the trust.

Second, clients must understand that the gifts are irrevocable: once made they cannot be taken back. (However, assets in some instances may be swapped during the trust period.)

Third, if the grantor dies before the termination of the trust and eventual gift, the planned reduction in the gift's value may be affected: a portion of the GRAT may be included in the estate under Section 2036. When the plan is established, depending on changes Congress may make, the annuity portion may become part of the decedent's estate or the balance may instead be added back to the remaining interest. The estate planner may, therefore, have to consider mortality tables for reversionary interests. Clients should be advised of recent court rulings and legislation regarding death prior to the trust termination.

Fourth, clients who set up the annuity trusts must be confident that there is adequate cash flow from the trust assets to enable the trust to make the guaranteed payments to the grantor. The full amount of payments must be made at least annually; debt instruments, options, or similar financial arrangements of the payment obligation are prohibited.

Fifth, grantor trusts may designate if the annuity payments are to be paid from, for example,

income only and not principal, or from all resources, including principal. Most advise that typically these trusts should be for "all purposes". Using an all purpose model permits the GRAT to hold S corporation shares, transactions between grantor and trust are ignored, and no gain or loss is recognized when the grantor sells assets to the GRAT or the GRAT sells assets to the grantor.

Sixth, the grantor of an all-purpose trust must report all items of income, credits, and deductions from trust assets regardless of the distributions made from the trust.

Grundmeier explained that there are different kinds of trusts, of which GRATs are only one kind. There are testamentary trusts created by will and there are living trusts created during life which can be either revocable or irrevocable. Both can be useful for avoiding probate, but revocable living trusts do not offer protection from taxes, creditors, or in divorce. With a revocable trust the trustor retains control but must pay income tax; however the trust is not subject to gift taxes and the trustor may either modify trust terms or take property back.

GRATs are irrevocable and are considered "tax related", as are A/B Trusts, Life Insurance Trusts, Charitable Trusts, and Dynasty Trusts. Non-tax related trusts include minors, special needs, and asset protection trusts.

"In all cases clients should seek appropriate legal counsel to determine what kind of trust, if any, is suitable, depending on a client's estate, the purpose, who will be trustee, what assets will

go into the trust, and what rules the trustee is expected to follow when managing the trust or making trust distributions," Grundmeier said.

Deal Making

(Continued from page 1)

2009, and the median was unchanged at 4.75 times. These multiples were higher than the 12 months ended in June 2009, according to the survey.

The average deal size was \$14.8 million in the 2010 first half compared to \$10.7 million in the 2009 last half. Deal size increased for M&A brokers but decreased for M&A advisors.

Minnesota Business Valuation Group President Randall Schostag said that there has been a noticeable increase in interest from firms soliciting MBVG for potential acquisition candidates. "The solicitations continue to stress quality of cash flow," Schostag said. "But at least there is now an interest where little was evident a year ago."

MBVG has been an ongoing AM&AA member nationally since early in the organization's formation and has also now become active in a Minnesota-based branch of the group, aimed at transactions, especially of private companies.

Local AM&AA professionals consist of David Cousins, Beta Partners; Terri Sheppard, Xact! Resources; Bud Sandberg, Wals & Associates, Ltd.; Joe Hugel, Gate to Improvement, LLC; Ken Engel, Esquire, Engle Professional Associates; and Don Keysser, Managing Principal, Hannover Consulting.

Professional Business Appraisals

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BUSINESS VALUATION

Goodwill Impairment Analysis (141/142)

Businesses

Intellectual Property

Intangible Assets

Options

Strategic Planning

ESOP

Divorce

Shareholder Oppression / Dissenting Rights

Buy/Sell Agreements

Merger / Acquisitions

Fairness Opinions /Purchase Allocation

Planning

BUSINESS ASSET VALUATION

Experts or Consultants

Sale / Purchase

Insurance

Fair Rental Rates

Financing

Ad Valorem Taxes

Condemnation

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Purchase Price Allocation

Property Records

Fiduciary Review

Sale / Leaseback Structuring

Business Planning

**WE ARE AVAILABLE FOR PRESENTATIONS FOR ESOP IMPLEMENTATION,
MERGER & ACQUISITION CONSIDERATIONS, EXPERT TESTIMONY PREPARATION,
GENERAL BUSINESS VALUATION, AND MANY OTHER TOPICS.**

OUR FORMAT IS POWER POINT - BASED.

**WE REQUEST THAT YOU SUPPLY THE SOUND SYSTEM AND APPROPRIATE DISPLAY
INSTRUMENT.**

WE WILL CONNECT OUR COMPUTER.

PLEASE ALLOW AT LEAST 30 DAYS FOR SCHEDULING.