MCM | WEALTH
BUSINESS EXITING | LEGACY PLANNING
WEALTH MANAGEMENT

Why Business Owners with Real Estate Should Plan Ahead Using Trusts Before Selling

Key Takeaways:

- **Plan Early to Save Big:** To significantly reduce taxes on appreciated real estate when selling your business, start advanced trust planning years beforehand; waiting until a sale is imminent limits your options.
- **Trusts Offer Diverse Tax Shields:** Utilize trusts like IDGTs, GRATs, or CRTs to cut capital gains and estate taxes, but understand each trust's specific purpose and essential timing.
- **Expert Guidance is Key:** Navigating these complex strategies requires professional legal and tax advice to ensure compliance and maximize your savings.
- **Balance Tax Strategies:** While trusts offer significant benefits, always weigh them against other considerations like the "step-up in basis" at death, especially for highly appreciated assets, to determine the most beneficial overall strategy for your specific financial situation.

For business owners who own the real estate their business operates from, the eventual sale of the enterprise can trigger a substantial tax liability, particularly on the appreciated value of the real estate. Without proactive planning, a significant portion of your hard-earned capital could be lost to taxes.

THE CHALLENGE: HIGH TAXES ON REAL ESTATE GAINS

When a business is sold, the real estate it occupies is often a significant asset, typically held for many years and experiencing considerable appreciation. This appreciation, when realized, is subject to capital gains taxes, which can be as high as 20% at the federal level, plus any applicable state taxes.

This can amount to a substantial sum, eroding the net proceeds from the sale. Furthermore, if the real estate is held personally rather than within the business entity, there can be additional complexities.

THE SOLUTION: PROACTIVE TRUST PLANNING

Trusts offer a versatile and powerful set of tools for mitigating these tax burdens. By strategically transferring real estate into various types of trusts, business owners can achieve several key objectives:

- **Reduce Capital Gains Taxes**: By shifting ownership and potentially creating new tax bases.
- **Estate Tax Planning:** Remove assets from the taxable estate, benefiting heirs.
- **Asset Protection:** Shield assets from creditors and lawsuits.
- **Control and Flexibility:** Maintain a degree of control over the assets even after transfer.

The critical element here is advance planning. Many of the most effective strategies require specific lead times to be valid and to fully realize their tax benefits.

Key Planning Methods and Essential Lead Times

Here are several trust-based planning methods commonly employed by business owners, along with their crucial timing considerations:

1. Irrevocable Grantor Trusts (IGTs)

An Irrevocable Grantor Trust, particularly a Grantor Retained Annuity Trust (GRAT) or an Intentionally Defective Grantor Trust (IDGT), can be highly effective.

How it Works: With a GRAT, the grantor transfers appreciated real estate to the trust and receives an annuity payment for a specified term. At the end of the term, any remaining appreciation in the trust passes to the beneficiaries tax-free. An IDGT is designed to be "defective" for income tax purposes (meaning the grantor still pays income tax on the trust's income) but effective for estate tax purposes (removing the assets from the grantor's estate). This allows assets to grow tax-free within the trust for the beneficiaries.

Tax Savings: Reduces capital gains taxes on the appreciation that accrues after the transfer to the trust and removes the asset from the grantor's taxable estate.

Lead Time: Crucial. To maximize the benefit, the real estate should be transferred to the IGT several years before a potential sale. The longer the asset is in the trust before the sale, the more appreciation can occur outside of the grantor's taxable estate. For GRATs, the annuity term needs to run its course. For IDGTs, the benefit accrues over time as the asset appreciates within the trust. A minimum of 2-3 years is often recommended for significant appreciation to occur, but longer is better.

2. Charitable Remainder Trusts (CRTs)

A Charitable Remainder Trust can be a powerful tool for highly appreciated real estate, especially if you have charitable inclinations.

How it Works: The business owner transfers appreciated real estate to a CRT. The CRT then sells the asset, and because the CRT is a tax-exempt entity, it pays no capital gains tax on the sale. The grantor receives an income stream (annuity or unitrust payments) for a set term or for life. When the trust terminates, the remaining assets go to a qualified charity.

Tax Savings: Eliminates upfront capital gains tax on the sale of the real estate, provides an income stream, and generates an immediate income tax deduction for the present value of the charitable remainder.

Lead Time: While a CRT can be established relatively close to a sale, it's ideal to set it up at least 1-2 years in advance. This allows for proper valuation of the real estate and ensures all legal formalities are completed without pressure. The charitable deduction is taken in the year the trust is funded, so planning allows for optimal utilization of this deduction.

3. Qualified Personal Residence Trusts (QPRTs)

While not directly applicable to business real estate in the traditional sense, if the business owner lives in a portion of the real estate or intends to use the proceeds to acquire a new personal residence, a QPRT can be relevant for personal real estate.

How it Works: The grantor transfers their personal residence into a QPRT for a specified term, retaining the right to live there. At the end of the term, the residence passes to the beneficiaries.

Tax Savings: Removes the value of the residence from the grantor's taxable estate at a significantly discounted value, as the value of the retained interest is subtracted.

Lead Time: At least 3-5 years before the expected sale or the end of the retained interest period. The longer the term the grantor retains the right to live in the home, the greater the discount for gift tax purposes. If the grantor dies before the term ends, the full value of the home is included in their estate, negating the benefit.

4. Spousal Lifetime Access Trusts (SLATs)

While primarily an estate planning tool, a SLAT can indirectly benefit from tax savings in a business sale context by removing assets from one spouse's estate while still providing indirect access to the assets for the other spouse.

How it Works: One spouse (the grantor) creates an irrevocable trust for the benefit of the other spouse (the beneficiary) and other descendants. The beneficiary spouse can receive distributions from the trust.

Tax Savings: Assets transferred to the SLAT are removed from the grantor spouse's taxable estate. If the real estate were transferred to a SLAT well in advance of a sale, its appreciation would occur outside the grantor's estate.

Lead Time: Several years before a sale. The longer the assets are in the SLAT, the more estate tax savings can accrue on appreciation.

CRITICAL CONSIDERATIONS FOR ALL PLANNING METHODS:

Appraisal and Valuation: Accurate and timely appraisals of the real estate are essential for all trust planning methods. This ensures proper gift tax reporting and maximizes the benefits of the strategies.

Step-Up in Basis: Be mindful of the "step-up in basis" at death. While trusts can offer significant tax savings, directly holding highly appreciated assets until death allows heirs to receive a new basis equal to the fair market value at the time of death, eliminating capital gains tax on prior appreciation. This needs to be weighed against the potential estate tax savings and asset protection offered by trusts.

State Laws: Trust laws vary by state. It is crucial to work with an attorney experienced in the laws of your specific jurisdiction.

IRS Scrutiny: Complex trust structures can attract IRS scrutiny. Proper documentation, adherence to all legal requirements, and conservative valuations are paramount.

Financial Goals and Risk Tolerance: The choice of trust depends on your individual financial goals, philanthropic desires, risk tolerance, and the desired level of control over the assets.

CONCLUSION: THE COST OF INACTION

Failing to plan in advance for the sale of a business with appreciated real estate is, in essence, choosing to pay more in taxes than necessary. The lead times required for effective trust planning are not merely bureaucratic hurdles; they are fundamental to the legal validity and tax efficiency of these strategies.

By engaging with experienced estate planning attorneys and tax advisors well in advance of a potential business sale, owners can strategically leverage trusts to significantly reduce their tax burden, preserve more of their wealth, and secure their financial legacy for generations to come. Don't wait until a buyer is at the door; the time to plan is now.

Disclaimer: This article is intended for informational purposes only and should not be construed as legal or financial advice. It is imperative to consult with qualified professionals to address your specific needs and circumstances.