Legal Strategies for Uncertain Economic Times

For most businesses, an economic downturn is hardly good news. However, there are some planning techniques that business owners can consider to extract benefit from a challenging economic climate:

- Employee Stock Awards and Stock Options

  For businesses that have been considering granting equity to employees, now may be a favorable time to do so from a tax perspective. Many businesses can justify a lower value for tax purposes than at any time in the recent past. This depressed business value allows a key employee to receive an award of unrestricted stock or to exercise a non-qualified stock option and incur less income tax than the employee would have incurred if the business had been required to use a higher valuation. Since employers often pay bonuses to employees to cover these equity-acquisition taxes, the business can achieve cost savings at the same time it is accomplishing a long term goal of employee ownership in the business.

- Convert from a C to an S Corporation and Minimize Built-In Gains Tax

  When a C corporation converts to S corporation status, the built-in gains in the corporation's assets as of the conversion date (for example, from appreciation of the business' goodwill value or other assets, such as intellectual property or real estate) will be double-taxed as if the corporation had not converted, if those assets are sold or otherwise disposed of in a taxable transaction within 10 years after the conversion. This rule does not apply to appreciation in the corporation's assets that occurs after the conversion date. A C corporation wishing to convert to S corporation status can take advantage of a depressed business value to minimize its future built-in gains taxes when the business is ultimately sold. To be effective beginning this year, an S corporation election must be made by March 15, 2009, and the company will need a recent business appraisal suitable for use in connection with the conversion.

- Maximize Annual Tax-Free Gifting

  In 2009, an individual may transfer up to $13,000 per beneficiary per calendar year ($26,000 per married couple) without incurring gift tax liability. For gift tax purposes, the amount of gift is based on the fair market value of the gifted property on the date the gift is made. For example, many individuals own publicly-traded securities that are currently trading at historically low price levels. Declines in values of securities may present an opportunity for the owner to gift a larger quantity of these securities to family members (thereby removing the securities from the owner's estate) and still stay below the annual gift tax exclusion. Likewise, the private business owner can transfer larger quantities of non-voting ownership in the business to family members (or to trusts or custodial arrangements where the donee is a child) and stay below the annual exclusion. Remember that the donee takes a carryover basis in the gifted shares. Note that transfers of securities to charitable institutions may not be advisable when the trading price of the securities is depressed, since the donor's charitable contributions deduction is based on the fair market value of the securities at the time donated to the charity. Also, be aware that pending federal legislation, H.R. 436, proposes to eliminate most discounts associated with gifts of interests in closely-held entities.

- Utilize a Grantor Retained Annuity Trust (GRAT)

With a GRAT, an individual transfers assets into a trust, which is established for a term of years, and an annuity is paid to the grantor during the term of the trust. At the end of the term, the assets of the trust become the property of the beneficiaries of the trust. The grantor is taxed on the difference between the fair market value of the property transferred to the trust as of the date of the transfer and the present value of the grantor's retained annuity interest using the IRS Section 7520 "hurdle rate." Set monthly, the hurdle rate as of February 2009 is at a historically low 2.0%. If the trust assets appreciate at a rate greater than the hurdle rate (which is fixed at the time the GRAT is established), then the appreciation of the trust assets above the hurdle rate will be transferred to the trust beneficiaries free from gift tax. Grantors can take advantage of the historically low hurdle rate as well as depressed asset valuations to potentially avoid gift taxes on a portion of the appreciation of the GRAT assets. A GRAT can be established using, among other assets, marketable securities or interests in closely-held businesses.

- Make Intra-Family Sales

An individual may sell to a younger family member in exchange for an interest-only promissory note with the principal due at maturity of the note. Currently, the minimum interest rate that may be charged on such a note is historically low (the applicable federal rate, or AFR, for February 2009 is 0.6% at present for loans of three years or less). When the note matures, the anticipated result is that the market will have rebounded, allowing a portion of the securities to be sold to pay off the note, with the buyer retaining the balance of the securities; or the note can be refinanced. This remaining portion is therefore effectively transferred to the younger generation free from gift tax. This strategy can be applied to assets ranging from public securities to interests in closely held businesses.

As with all planning techniques, no one strategy works in every situation. Therefore, careful analysis of the client's goals and financial situation is needed to determine which, if any, of the above strategies is appropriate in a given situation.

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