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Estate & Succession Planning 201:
Wealth Transfer Strategies

PRESENTED BY

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Overview

- Financial Readiness for Owners
  - Preparation for Ownership Transition
- Personal Readiness for Owners
- Sale of a Business
- Gifting Strategies
  - Irrevocable Gifting Trusts
  - Installment Sales to Defective Grantor Trusts
  - Life Insurance Trusts
  - Charitable Planning
- Dynasty Trusts & Generation Skipping Transfer Tax (GST)
- S Corp Planning – QSST's and ESBT's

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Recap of Session 101:

- Business Succession Planning
  - Business Ownership Succession
  - Buy-Sell Agreements
- Personal Succession Planning
  - Basic Estate Documents
  - Avoiding Probate
  - Estate & Gift Tax Basics
  - Why Are Trusts Set Up?
  - Types of Trusts
    - Revocable Living Trusts
    - Irrevocable Trusts/Grantor Trusts

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Financial Readiness for the Owners

- Biggest questions business owners have before a sale:
  - Do I have enough money to live the way I want?
  - Will I run out of money?
- What potential challenges do owners face after a sale
  - Relying on investments for income replacement
  - Making the capital last for the rest of their life
  - Dealing with the uncertainties of the financial markets
  - Inflation, low interest rates, and market risks can be significant threats

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Preparation for Ownership Transition

- Putting your financial house in order – developing a personal financial plan
  - Develop net worth statement
  - Review current investments and asset allocation
  - Review insurance needs
  - Review living expenses and estimate future cash flow needs
  - Model different "what if" scenarios regarding business value
  - Determine appropriate asset allocation

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Personal Readiness of the Owners

- Developing a plan for life after exiting the business
  - Most neglected step of the process
  - What does happiness look like after the exit?
    - Business consulting or board of director's service
    - Charitable endeavors
    - Community involvement
    - Hobbies
  - Develop a schedule to manage your time and provide structure to your life on a daily basis

Poll Question #1

What is your biggest concern in terms of retiring/exiting the business?

A. Meeting cash flow needs
B. Avoiding estate taxes/Minimizing income taxes/maximizing step-up in basis at death
C. Orderly transition of the business to next generation/future owners
D. Developing a plan for life after the sale/retirement

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Stock Sale vs. Asset Sale

- Generally buyers prefer asset sales whereas sellers prefer stock sales
- Primary concerns are:
  - Tax implications
    - Buyer wants step up in basis for depreciable assets
    - Seller receives capital gain tax rates on stock sale, but sale of hard assets results in higher tax rate due to ordinary income recapture
    - C Corp has double taxation issue on asset sale.
    - S Corp can elect to treat stock sale as asset sale for tax purposes
  - Potential liabilities
    - Buyer assumes certain liabilities but leaves others with seller
    - Contingent liabilities can be mitigated in a stock sale

Estate & Gift Tax Basics - Recap

- Estate & Gift Exemption - $12,920,000 for 2023 ($25,840,000 jointly)
- Current Exemption sunsets at 12/31/25, likely dropping to about $7,000,000 ($14,000,000 jointly) for 2026.
- Estate/Gift tax rate is effectively 40% of the net taxable estate
- For individuals under the exemption amounts, focus on income tax basis planning and maximizing use of tax deferred retirement accounts/Roth retirement savings

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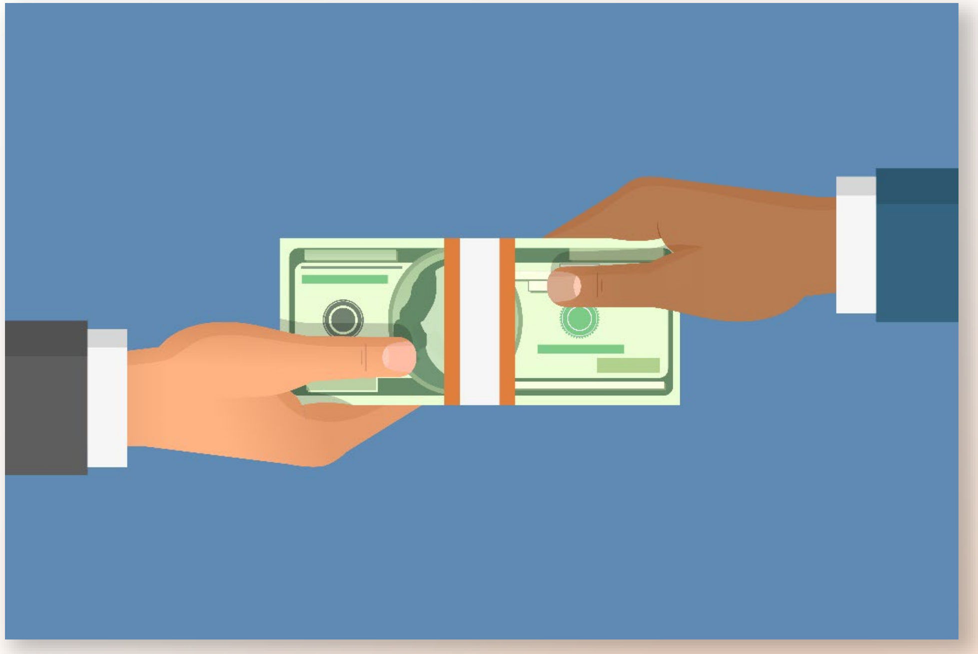
Gifting Strategies: Gift it Away

- Gifting ownership is a simple approach
  - Outright
  - Irrevocable trust
    - Intentionally Defective Grantor Trusts (IDGTs)
    - Spousal Lifetime Access Trusts (SLATs)
- Valuation & gift tax return filing required
  - "Valuation discount" is an important part of the strategy
- Carryover basis
- Remove future appreciation from the estate



Intentionally Defective Grantor Trusts – Refresher

- A trust that is not recognized for income tax purposes because the grantor to the trust retains certain rights over the trust
  - Revocable living trusts are one example
  - Irrevocable trusts that are "defective" due to rights retained by the grantor
- Grantor is treated as owner and taxed with part or all income, deductions, gains and credits
- Grantor retains certain administrative powers over the trust
  - **Power to substitute property in the trust – by far the most common "defect"**
  - Power to borrow from the trust without adequate security
- Can help accomplish 4 goals:
  - Irrevocable transfer, so uses up estate & gift exemption
  - Freeze value of assets still in the estate, while gifted assets grow outside
  - Valuation discount
  - Avoids probate

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Spousal Lifetime Access Trusts (SLATs)

- A type of irrevocable gifting trust used by married couples
- One spouse (grantor) gifts assets to a trust for the benefit of:
  - Spouse while still living
  - Children
  - Future descendants – “Dynasty Trust”
- Typically, no mandatory distributions of income to anyone during spouse’s lifetime
- Almost always set up as a “defective grantor trust” taxable to the grantor
- Spouse is often the trustee
- Advantages:
  - Can gift away the full $12,920,000 and spouse retains access to it if assets are ever needed
    - Deals with a very common concern of owners: “What if I give this away and run out of money?”
  - Assets grow tax free outside of taxable estate
  - Good option to use “Generation Skipping Tax” Exemption so assets are free of estate tax forever

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Installment Sales

- Full purchase price financed by seller at the IRS AFR – about 4% currently
- Buyers use business cash flow to fund note payments
- Income stream to seller from note repayment
- Buyers have basis equal to purchase price
- Taxable gain to seller
  - Minimized with discounted valuations
  - Spread out over the term of the note

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Poll Question #2

Which of these statements best summarizes your general philosophy on tax planning?

A. Do whatever it takes to save the most tax dollars. Complexity is fine if it generates net savings.

B. Pursue tax savings opportunities, but prefer an approach with less moving parts, even if that generates some extra taxes

C. Keep it very simple and capture the low hanging fruit, but don't worry about paying some extra taxes over time.

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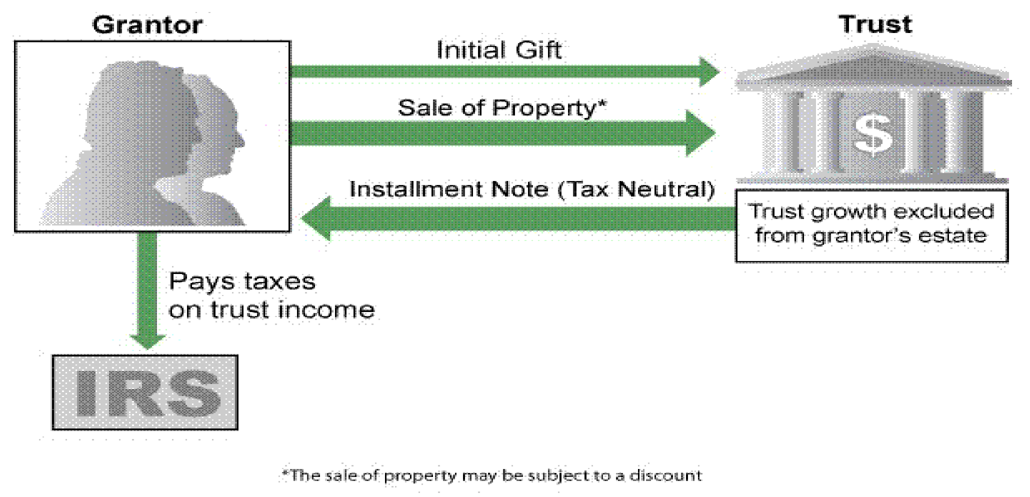
Installment Sales & Intentionally Defective Grantor Trust (IDGTs)

- Seed gift uses some estate exemption
  - Lower valuation reduces this impact
- Remaining interest financed by seller with note at the AFR (4%)
- Eliminates taxable gain to seller since defective
- Carryover basis for buyers
- Efficient GST planning vehicle



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Installment sale to IDGT Example

- $10M FMV
- 20% valuation discount (15-35% range)
- $8M discounted value
- Assume annual cash flow = $1,430,000 (7 X multiple)

- $800,000 seed gift to trust
- $7.2M sale to trust via 9-year note
- Mid-term AFR 3.85% (July 23)
- $1,053,180 annual P&I payments
- Total interest $1,478,500
- Could instead use interest-only with a balloon payment
- Net effect is transfer of $10M of stock while using only $800,000 of exemption
- Trust assets at note payoff = $14,155,000

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Irrevocable Life Insurance Trusts (ILITs)

- Often used by business owners to finance estate taxes on transition of the business to the next generation
  - When business value represents a large % of the overall net worth
  - Liquid assets are needed to pay estate tax at death
  - Heirs don’t want to sell the business

Irrevocable Life Insurance Trusts (ILITs)

- Steps:
  - Trust is set up and the trustee takes out a permanent insurance policy on the grantor, $10M for example
    - If married, normally a joint life policy would be taken out if estate tax won't be due until the second death
  - Or grantor can gift an existing policy to the trust, or both
  - Grantor gifts cash to the trust each year to fund the annual insurance premium.
    - Annual exclusion gifting for each trust beneficiary utilized to minimize the use of estate & gift exemption
    - Often the only asset of the trust is the insurance policy
  - At the death of the grantor/surviving spouse if married, cash drops into the LI Trust from the policy
  - Trust purchases shares of the business from the estate using the cash.
  - Estate now has cash to pay the estate tax on the business and the trust owns the shares for the benefit of the beneficiaries
- Advantages:
  - A fairly simple and tax efficient way to accumulate liquid assets in an illiquid estate
  - Assets grow income tax free inside the life insurance policy

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Poll Question #3

What types of life insurance policies do you own currently in your own name?

A. None, other than some term coverage owned through my employee benefits
B. Term life policy (outside of employee benefits)
C. Permanent life policy (Whole life, universal life, variable life)
D. Both term & permanent policies

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Charitable Planning – Year of Sale

- Donor Advised Fund
  - Simplest approach, maximum deductibility at 60% of AGI for cash donations
  - Allows you to fund many years of future charitable contributions with tax deduction matched to high income from sale
  - Large local organizations and brokerage firms likely have platforms available
  - Potential to donate shares of company prior to sale and avoid cap gains
- Private Foundation
  - Much more complex to set up and administer, but nice option if one already exists
  - Tax deductibility limited to 30% of AGI for cash donations

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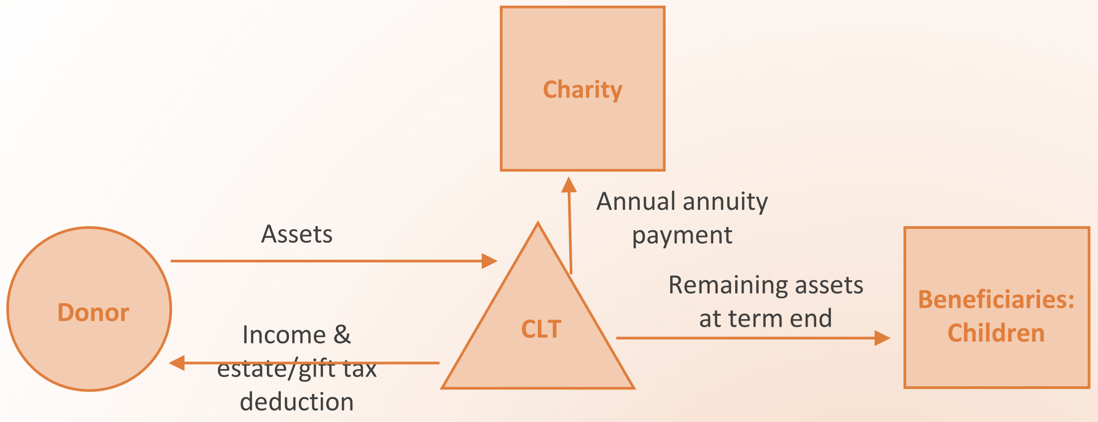
Charitable Planning: Charitable Lead Trusts (CLTs)

- Split interest charitable trust with income tax deduction available year of funding and a taxable gift
- Under Trust Terms:
  - "Guaranteed" annual payments to charity, calculated under IRS rules
  - Excess appreciation to heirs at the end of the trust term
  - "Hurdle rate" is currently 5%
- Charitable beneficiary options: Restrictions on family foundations
- Non-Grantor vs. Grantor
- Generally not used for GST transfers



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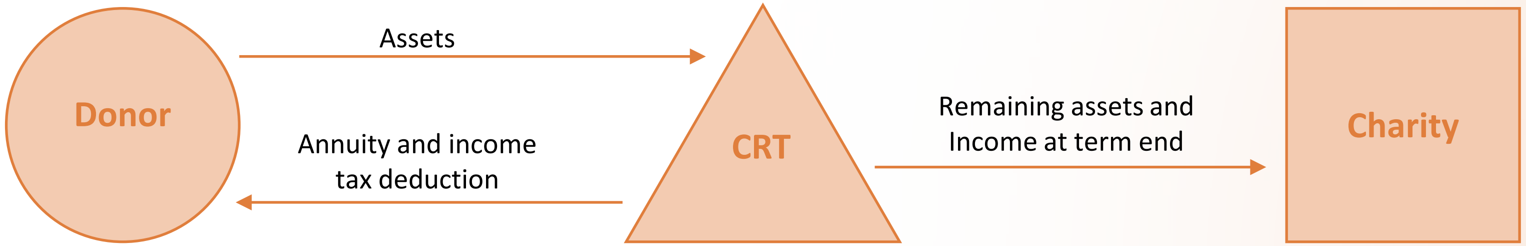
Charitable Remainder Trusts (CRTs)

- Split interest charitable trust with income tax deduction in year 1
- Payments to trust beneficiary with annuity amount calculated under IRS rules
- Annuity is normally paid out quarterly
- Remaining trust assets to charity at end of trust term
- Charitable beneficiary options: Restrictions on family foundations



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Dynasty Trusts & Generation Skipping Transfer Tax (GST)

- Dynasty trust is one that retains assets in trust beyond the next generation
  - Protects assets from lawsuits against beneficiaries/beneficiary divorce
  - For taxable estates, trust assets can be exempted from future estate tax
- GST - Second layer of estate & gift tax imposed on assets transferred to anyone more than one generation below the transferor
  - Annual exclusion of $17,000 is available (but not usually for gifts in trust)
  - GST Exemption equal to $12,920,000 is also available
  - Transfers in excess of that are subject to this tax
- Common planning strategy is to gift assets to a "Dynasty" trust and allocate GST Exemption to the gift so trust assets avoid any future estate tax/GST

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Poll Question #4

What areas are you most interested in hearing more about in future education sessions?

A. Developing a personal financial plan
B. Maximizing retirement plan savings under the new distribution rules
C. Additional wealth transfer strategies
D. Provisions to consider including in your trust documents

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Trusts as S Corp Shareholders

- Grantor Trusts
  - Automatically qualify as S shareholders.
  - Grantors are treated as the shareholders for all tax purposes.
- For non-grantor trusts, there are limitations on which trusts can be S Corp shareholders.
  - ESBT and QSST are eligible shareholders.
  - Estates - temporarily

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Qualified Subchapter S Trust - QSST

- An irrevocable trust may be treated as a grantor trust through a QSST election **made by the beneficiary**.
- Requirements of QSST:
  - Can have only one beneficiary, separate shares can qualify
  - Beneficiary must be a U.S. citizen or resident
  - Beneficiary may receive income or corpus during the beneficiary's lifetime
  - All of trust income must be distributed currently to the beneficiary while the trust holds S stock.
- Most appropriate when the trust is required to distribute income currently to one beneficiary with no other current beneficiary

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Electing Small Business Trust - ESBT

- ESBT income taxation is complicated.
  - Tax is paid by ESBT, at the highest individual tax rate.
  - Few deductions are allowed against this income
  - Income distribution deduction is not available.
- Income can be accumulated in the trust, so can be an option where trustee wants to retain income. (When there are minor children for example)
- Complications arise if the ESBT is a grantor trust, CLT, or other trust eligible for a charitable income tax deduction.

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Thank You!

Please join us for the final webinar in this series:

Inflation Reduction Act: Incentives for Investment in Energy Efficiencies and Emerging Technologies

Wednesday, August 16

11 a.m. to Noon EDT

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