Estate & Income Tax Considerations in a Business Succession Plan

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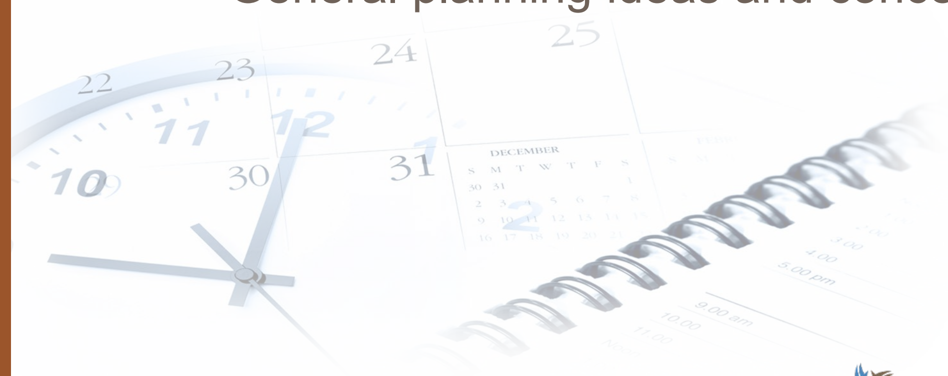
Agenda

- Review of Estate Planning key terminology
- Biden Tax Proposals
- Gain a basic understanding of trusts and why they are created in conjunction with an estate plan
- Review the benefits and tax implications of planning with trusts
- General planning ideas and concepts



Terminology

TRUSTS

VALUATION & DISCOUNTING

ESTATE TAX

INTER-VIVOS

WILL

INHERITANCE TAX

INCOME TAX

CHARITABLE PLANNING

ESTATE & GIFT TAX EXEMPTION

Terminology

- **Trusts** – key estate planning vehicle (*future slides dedicated to various types of trusts)*
- **Valuation & Discounting** – available for transfers of private companies, family limited partnerships and real estate partnerships
- **Estate/Gift Tax** – federal tax of up to 40% on gifts made during lifetime (**inter-vivos**) or tax paid at death based on estate value
- **Estate/Gift Tax Federal Exemption**: exempts gifts and transfers at death to estate/gift tax up to allowable amount. For 2021, the personal federal estate tax exemption amount is $11.7 million. A married couple has a combined exemption for 2021 of $23.4 million

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Terminology

- **Generation Skipping Transfer Tax:** The generation-skipping transfer tax (GSTT) is a federal tax that results when there is a transfer of property by gift or inheritance to a beneficiary who is at least 37½ years younger than the donor. There is a GSTT exemption which currently equals the estate/gift tax exemption
- **Will** – Provides direction and management of deceased's assets
- **Inheritance tax** – State tax that subjects **transfers at death** to tax (PA tax ranges from 0% to 15%)
- **Income Tax** – Federal and state tax on income
- **Charitable Planning** – Ability to make lifetime donations or contributions at death. Several vehicles available including trusts and donor advised funds

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Terminology – Deeper Dive

Valuation & Discounting

- A valuation is used as a means to value an interest in such things as a private company, family limited partnership or a real estate partnership.
- When an exchange is being contemplated for gift tax purposes, a valuation is a requirement for the gift tax return.
- For gift and estate tax purposes, the fair market value of property transferred to another party is measured on the date of the transfer as “the price at which the property would change hands between a [hypothetical] willing buyer and a willing seller, neither being under any compulsion to buy or to sell and both having reasonable knowledge of relevant facts” (the “willing-buyer, willing-seller test,”).

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Terminology – Deeper Dive

Valuation & Discounting

- The valuation is completed by a certified professional using IRS accepted methodologies
- The ability to discount the freely tradable value is also an allowable methodology to arrive at the value of the gift
  - Lack of Marketability: Discounts for lack of marketability (DLOM) refer to the method used to help calculate the value of closely held and restricted shares. The theory behind DLOM is that a valuation discount exists between a stock that is publicly traded and thus has a market, and the market for privately held stock, which often has little if any marketplace.
  - Lack of control: Discount applied to a non-controlling ownership interest in a small business.

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Terminology – Deeper Dive

Valuation & Discounting

- Example: Family Real Estate Partnership gifting real estate LLC interest to trusts FBO children (donor retained control of voting units)

The adjusted net assets method yields a valuation, before discounts, as follows:

Net book value as of December 31, 2020 (Exhibit A-1)	$	1,148,626
Fair market value of real estate in excess of recorded value		723,892
Valuation, before discounts (rounded)	$	1,873,000

Valuation, before discounts (rounded)	$	1,873,000
Combined discount for lack of control and lack of marketability (36%)		(674,300)
Valuation conclusion, non-marketable, non-controlling	$	1,198,700

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Biden Tax Proposal

Biden Tax Proposal

- Increase top individual tax rate to 39.6% (from 37%). The 39.6% rate was the top rate prior to the TCJA of 2017
- Increase the long term capital gain and qualified dividend rate to 39.6% (from 20%) for those with adjusted gross incomes of $1 million or more
- Apply the self employment tax and the net investment income tax more uniformly/consistently for those making over $400,000

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Biden Tax Proposal

- Eliminate "step up in basis" for inherited property (**see below**)
- For transfers of a partial interest there appears to be no discounting
- Transfers to trusts, partnerships or other non corporate entities (other than certain grantor trusts) would be a recognition event (**see below**)
- Realization of gain for appreciated securities gifts and transfers at death – subject to capital gains tax (**see above**)
- Potential reduction in estate/gift tax exemption?
  - The Biden **campaign** proposed to reduce the Estate Tax exemption amount to $3.5 million per spouse, and to increase the top rate for the estate tax to 45%
- Estate/gift tax exemption sunsets at end of 2025 – back to ~$6M per spouse

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Biden Tax Proposal - Impact

- Lisa owned a very successful consulting business that she started as a young professional, but that grew to be worth $10M. She previously fully utilized her gift and estate tax lifetime exemption amount (along with any other exemptions or credits) making gifts to her children.
- Lisa passed away in 2022 leaving her stock (with zero basis) to her children……..

Stock	$10,000,000
Capital Gains Tax (including NIIT)	43.6%
Capital Gains Tax	$4,340,000
Estate Value (after deduction for capital gains tax paid)	$5,660,000
Estate Tax Rate	40%
Estate Tax	$2,264,000
Total Taxes	$6,604,000 (66.04%)
Remaining for Heirs	$3,396,000 (33.96%)

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Trusts

Trust Vs. Will

Assets transferred

during life of grantor

Trust

upon death by

Will

NO Probate

WHY??

PROBATE

Estate Planning
Transfer to Heirs

Estate Planning
Transfer to Heirs

Definition of a Trust

- A legal arrangement whereby an individual (the settlor or grantor) transfers property to another person (the trustee) so the property can be administered for the benefit of a third party (the beneficiary).
- The terms and conditions of a trust are set out in the written instrument that creates the trust, usually a will or trust agreement.

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General Terms

- **Grantor:** Creates the trust; determines it's terms and conditions; and generally gives assets to the trust
- **Settlor:** In law, a person who settles property for the benefit of beneficiaries. In some legal systems, a settlor is also referred to as a ***trustor, grantor or donor***.
- **Trustee:** Holds legal title to the assets, manages the property and makes distributions from the trust. A trustee is appointed by the grantor in the trust instrument and must follow its terms and conditions
- **Beneficiaries:** Persons selected by the grantor to benefit from the trust.

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Why Create a Trust?

Trusts can be created for many purposes, but the most common are when they are used in estate planning to postpone receipt of a gift or inheritance and to provide management of assets for beneficiaries who are unable to personally manage them.

Accounting and Tax Implications for Trusts

Accounting and Tax Implications for other Trusts

What if you have a non-grantor type trust?

- Fiduciary Accounting Income
  - Trust accounting concept that provides for the amount of annual net income that is retained as principal within the trust, or part of the trusts annual income that is eligible for distribution to its beneficiaries
  - Principal: stays in trusts
    - Think – capital gains
  - Income: eligible to be passed out to beneficiary
    - Think interest, dividends, certain types of business income, S corporation distributions
  - Why does it matter?
    - Annual impact on trust and beneficiary

Accounting and Tax Implications for other Trusts

What if you have a non-grantor type trust?

- Simple vs. Complex (governed by trust document)
  - Simple trust: **required** annual distributions of distributable accounting income to beneficiary (QSSTs are Simple Trusts)
  - Complex trust: annual review of accounting income, but distributions are not required (ESBTs are generally complex trusts)
- Tax Implications
  - Impact on who pays the tax
  - Ability to manage brackets and transfer of wealth (think GSTT implications)
  - Ability to manage Net Investment Income Tax
- Trust Tax Rates vs. Individual Income Tax Rates
  - Trust hits top bracket at $13k
  - Single individual = $524k

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Common Types of Trusts with Business Ownership

Grantor Trusts

- Definition: A legal trust under state law that is not recognized as a separate taxable entity for tax purposes
- ALL income and expenses flow directly to grantor's individual tax return
- General purpose:
  - Allows the grantor the ability to preserve the wealth they have accumulated
  - Maintain significant rights to the trust's assets and income
  - Provides asset protection for their beneficiaries
  - Minimize the ultimate tax burden to the beneficiaries
  - Ability to keep the assets OUT of the grantor's taxable estate at death

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Gift stock to trust

Individual's estate is reduced by FMV of stock

Any appreciation of stock will be in trust

Decrease:
Value of stock and taxes paid
Increase:
Required distributions

Tax effect:
Annual income from trust flows to Grantor who pays federal and state taxes

Increase:
Value of stock
Decrease:
Required distributions

Qualified Subchapter S Trusts (QSST)

- Allows a trust to own S Corporation stock
- Ability to make a gift of all or part of S Corporation while retaining the voting power
- All income must be distributed to SINGLE beneficiary who is typically someone other than the grantor of their estate
- Annual income of the S Corporation is taxed at the beneficiary level
- Important to note, the capital gain on the sale of the S Corporation stock is taxed at the trust level

Gift stock to trust

Individual's estate is reduced by FMV of stock while retaining voting power

Any appreciation of stock will be in trust

Decrease:
Value of stock and taxes paid
Increase:
Required distributions

Tax effect:
Annual income from trust flows to Grantor who pays federal and state taxes

Increase:
Value of stock
Decrease:
Required distributions

Electing Small Business Trust (ESBT)

- Definition: A trust that retains ownership as the shareholder of an S Corporation
- Income is taxed separately, but filed as one trust
  - Income from investments held by the trust may flow out to the beneficiaries
  - Income from S Corporation taxed at the trust level

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Gift stock to trust

Individual's
estate is reduced
by FMV of stock

Any appreciation of
stock will be in trust

Decrease:
Value of
stock

Tax effect:
Income from business
taxed at trust level

Increase:
Value of stock and
yearly distributions
Decrease:
Taxes paid

POLLING QUESTION

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Other Planning Considerations

Charitable Remainder Annuity Trust (CRAT)

- Type of gift transaction in which a donor contributes assets to a charitable trust which pays a fixed income to a designated beneficiary (can be donor or another individual) in the form of an annuity
- Trust is considered a tax-exempt entity therefore assets sold within the trust do not trigger a taxable event, which increases the assets' income potential
- Value of the annuity is calculated as a **fixed percentage** of the initial value of the trust's assets, with a minimum distribution of 5%
- Guarantee income stream to beneficiary every year
- Income tax deduction for the present value of the remainder interest
- CRAT will continue until the donor passes away, at which time any funds remaining in the trust are then donated to a charity pre-chosen by the donor
- What can be donated? Cash, publicly traded securities, real estate and certain other complex assets
- RISK? Trust may "run out" of money if the annual earnings do not meet and/or exceed the fixed percentage
- Irrevocable

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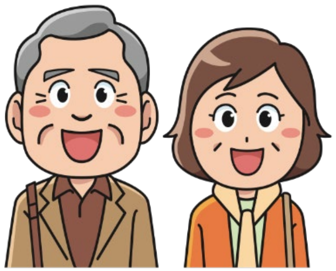

Gift stock to trust

Individual's estate is reduced by FMV of stock

Any appreciation of stock will be in trust

Decrease:
Value of stock, charitable deduction, and taxes paid
Increase:
Required distributions

Tax effect:
Fixed amount of income to beneficiary each year

Increase:
Value of stock
Decrease:
Required distributions

Charitable Remainder Unitrust (CRUT)

- Another estate planning tool that provides income to a beneficiary during the grantor's life. Upon passing of the grantor, the remaining assets of the trust are donated to a charitable cause.
- Trust is considered a tax-exempt entity therefore assets sold within the trust do no trigger a taxable event, which increases the assets' income potential
- The beneficiary is typically the donor or family members
- Income to beneficiary is based on a **percentage of the fair market value** of the assets in the trust. The amount is **revalued each year**. Because of this, the amount of income to the beneficiary varies each year.
- CRAT will continue until the donor passes away, at which time any funds remaining in the trust are then donated to a charity pre-chosen by the donor
- Minimum of 10% of the asset's value are required to be paid to the charity
- Immediate income tax deduction for portion of the contribution to the trust
- What can be donated? Cash, publicly traded securities, real estate and certain other complex assets
- Irrevocable

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Gift stock to trust

Individual's
estate is reduced
by FMV of stock

Any appreciation of
stock will be in trust

Tax effect:
Percentage of income to
beneficiary each year

Decrease:
Value of stock,
charitable deduction,
and taxes paid
Increase:
Required distributions

Increase:
Value of stock and
yearly income
Decrease:
Required
distributions

Qualified Personal Residence Trust (QPRT)

- Grantor creates a QPRT for a term of years and designates beneficiaries, typically family members
- Properly structured QPRT will freeze the value of the residence at the time the trust is created
- Does NOT qualify for the annual exclusion because it is not a gift of present interest
- Grantor retains the exclusive rent-free use, possession and enjoyment of the residence during the life of the QRPT.
- Grantor pays any ordinary and reoccurring expenses such as real estate taxes, insurance and minor repairs
- For estate tax purposes, the grantor must outlive the term of the trust.
- If grantor dies before the trust expires, the date-of-death value of the QPRT will be included in the grantor’s estate and is subject to estate taxes
- Grantor’s basis in property transfers to beneficiaries

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Gift house to trust

Couple's estate is reduced by FMV of residence

Any appreciation of residence will be in trust

Decrease:
Value of residence and real estate taxes & expenses paid

Tax effect:
Expenses, such as real estate taxes and repairs, paid by Grantor

Increase:
Value of residence

Delaware Resident Trust

- A trust created under the laws of Delaware with a Delaware trustee (typically a corporate trustee)
- Delaware provides extremely favorable tax treatment to trusts for nonresident beneficiaries. While the trust is considered a Delaware resident trust for tax reporting purposes, the tax law provides a deduction for income accumulated for nonresidents.
- So long as the beneficiaries reside outside Delaware, no Delaware income tax is imposed on the trust
- Delaware imposes no tax on income distributed to a nonresident beneficiary. Income subject to tax is taxable under the laws of the beneficiary's state of residence. A trust with all nonresident beneficiaries will pay no Delaware income tax, directly or indirectly.
- Typically an ESBT
- Planning Opportunity – high tax states (NJ, NY)

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Gift stock to trust

Individual's estate is reduced by FMV of stock

Any appreciation of stock will be in trust

Decrease:
Value of stock

Tax effect:
Trust can retain income – current income and accumulated income: no DE state income tax

Increase:
Value of stock and yearly distributions
Decrease:
Taxes paid

Spousal Lifetime Access Trust (SLAT)

- Definition: an irrevocable trust where one spouse makes a gift into a trust to benefit the other spouse (and potentially other family members) while removing the assets from their combined estates
- Provides an opportunity to take advantage of the current federal lifetime gift and estate tax exclusion before it expires on December 31, 2025
- Properly structured, a SLAT will provide the donor limited, indirect access to the trust assets
- Typically set up as a Grantor trust, allowing Grantor spouse to pay the trust's income taxes
- While spouse can take distributions from trust, they are only recommended after exhausting other available resources since any distributions would be brought back into their taxable estate and the ultimate goal of a SLAT is to let the assets grow outside the estate
- Downside: no step-up in basis upon death of donor

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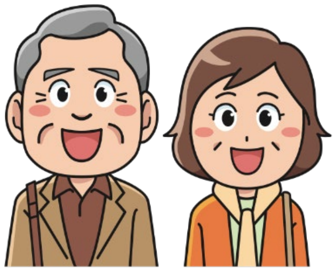

Gift stock to trust

Individual's
estate is reduced
by FMV of stock

Any appreciation of
stock will be in trust

Tax effect:
Earnings are taxed at Grantor level but recommended to keep income in trust

Decrease:
Value of stock and taxes paid

Increase:
Value of stock and yearly earnings

Final Thoughts and Considerations…

- S Corporation stock – grantor trust, QSST & ESBT are eligible shareholders
- Given the current tax environment, consider gifting family business and/or other assets as part of an overall effective estate plan
  - Recall the benefit of valuation discounts
- Be mindful of the income tax considerations of certain vehicles
- Holistic approach – attorney, investment advisor and accountant

Contact the Presenter

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Brian has a wide range of experience providing domestic and international tax planning and compliance services to a variety of middle market companies and entrepreneurial businesses in a number of industries, including manufacturing, distribution, media, real estate, financial, and professional services. He has also assisted companies with business transactions, including mergers, acquisitions, and transition planning. He has significant experience in federal, state, and local tax audits, settlements, and appeals.

As an advisor to his clients, Brian uses his experience to ensure all tax incentives are being considered, including federal and state research and development tax credits, utility sales tax exemptions, and, for domestic manufacturing clients with significant exports, the Interest Charge Domestic International Sales Corporation.

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Lisa provides a variety of tax services including tax compliance, tax planning, and tax research for corporations, multi-state companies, partnerships, trusts and high-net-worth individuals. Lisa participates in developing and presenting professional in-house training on topics relating to individuals and trusts.

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