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Transfer Tax and Succession Planning – Seize the Moment

By Scott Nelson of Mackall, Crounse & Moore, PLC

Introduction: In a recent survey by SEI, only 46% of wealthy families said they have a wealth transfer strategy or plan in place, while more than 38% said they had prepared a Will and nothing else. 80 percent said they expect to pass on their wealth directly to family members, and 97% said they believe the next generation has the ability to continue creating wealth and improving the lives of their families.

With the recent changes in the U.S. transfer tax system, our government has provided a golden opportunity for families with a significant portion of their estate in the form of closely-held business arrangements, farms, or concentrated positions in a particular company, and families planning to tax-efficiently pass wealth to future generations.

Succession Planning: For business owners, it is also important to coordinate their estate planning with business succession needs. Steve Jobs is a recent reminder that the process works well if initiated well ahead of any disability or death. With the assistance of the experts at Sage Hill, there are experts ready to coordinate this process. The first step is to make sure that your financial advisor has analyzed your lifestyle, capital needs, and any philanthropic objectives you may have, before we begin considering the different options available to you for transfer tax purposes. In the business succession process, the goal is to ensure the survival and growth of the business. As an appendix, I have provided a copy of a succession-planning checklist that addresses some of these issues. The goal of your estate planning is to preserve family harmony, minimize taxes, facilitate retirement, and achieve your legacy goals.

The remainder of this article is focused on the wealth transfer opportunities that are currently available under the tax law.

2010 Act. Going beyond any reasonable expectations in the practitioner community, Congress and the President enacted 11th hour legislation in the Tax Relief, Unemployment Insurance Authorization, and Job Creation Act of 2010 ("The 2010 Act"), which was signed by the President on December 17, 2010. It increased the federal estate tax exemption from $3.5 Million in 2009, to $5.0 Million in 2010-2012. In addition, they increased the gift tax exemption from $1 Million in 2010 to $5 Million in 2011 and 2012. With the inflation adjustments announced by the Department of Treasury in IR-2011-104, the estate tax exemption for decedents dying in 2012 will be $5,120,000.00, while the gift tax

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exclusion remains at $5 Million. The gift tax exemption is the amount that can be transferred cumulatively during lifetime without incurring any gift tax, although you reduce the available estate tax exemption at death based on the amount of "taxable gifts" that you made during lifetime. In most cases, a gift of less than $13,000.00 per person per year is not considered a taxable gift for this purpose.

Annual Exclusion: If you can afford it, it is always advisable to take advantage of the annual exclusion which cannot be carried over to another year. There are several techniques available to ensure that both the husband and wife are taking full advantage of the annual exclusion, and there are arrangements which allow you to leverage the annual gifts through available discounting of the transfer. Typically this involves the transfer of minority interests in a family entity, with restrictions on sale and/or ability to participate in the management of the enterprise, creating discounts in the value to the recipient as recognized in guidance provided by the Department of the Treasury and extensive case law.

Immediate Action. With the $5 Million gift tax exclusion, enormous opportunity has been created to allow transfer of significant wealth between now and the end of 2012. Although the gift tax exemption may be extended, it is currently scheduled to revert back to $1 Million in 2013 in the absence of congressional action. The same is true with the estate tax exemption, and the top estate tax rate will increase from 35% to 55% (with a possible 5% surtax on estates between $10 Million and $20 Million, which is designed to eliminate the exemption benefit on the first $1 Million). At the time of this writing, the Congressional Joint Select Committee on Deficit Reduction is due to issue its recommendations by November 23rd, and Congress would have an up or down vote on the recommendations by December 23rd. It may include some suggestions for revenue raisers that impact the transfer tax system in 2013 and later. There has been conjecture in the press about possible earlier implementation, but that appears unlikely given the economy and the 2012 elections.

GST. For any irrevocable transfers to the second generation or beyond (typically grandchildren), there is an additional planning obstacle called the Generation Skipping Tax (the "GST"). Intended as a way to prevent avoidance of estate tax at the level of the first generation, the GST is imposed in addition to the estate tax, but with plenty of planning opportunities available to minimize or avoid this assessment. As with the estate tax, the current law provides a golden opportunity until the end of 2012 by providing a $5 Million per person exclusion for GST purposes. If you are motivated to consider planning for future generations, you may consider for example a "Dynasty Trust" which will keep the assets intact for

the second generation and beyond, and will utilize your gift tax and GST exemptions upon funding.

Low Interest/Valuation. In addition to the increased levels of exemption, we are in a low-interest rate environment, and frequently a relatively low current valuation for many of our assets. This can create ideal conditions for considering large current gifts to your beneficiaries, either outright or in various trust arrangements available to you. In addition to taking advantage of valuation discounts, the transfers can be structured to remove all future appreciation from your estate, and in most states where there is no state level gift tax regime, the ability to avoid transfer taxes completely for state purposes. At this time, only Connecticut, Tennessee and Puerto Rico impose a gift tax, while about 20 states have an estate or inheritance tax upon death. You also need to check your local law to determine whether they may have a Generation Skipping Tax.

Some drawbacks to lifetime gifting that need to be considered include:

1. Whether you can afford to transfer the income and principal during lifetime.

2. Whether the particular asset is a good candidate for the gift. For example, you would in most cases wish to avoid any gifts of assets that end up losing value after the exemptions have been used.

3. Because the income tax basis in gifts normally carries over to the recipient, with low-basis assets you need to consider whether it is better to transfer them now, or retain those in your estate and potentially receive a “step-up in basis” upon death.

4. Under the current law, with its scheduled expiration at the end of 2012, there is a possible “clawback issue.” In brief, although the current gift tax exemption is $5 Million, the question arises as to what happens for individuals who die after 2012 when the estate tax exemption is possibly lower than the current gift tax exemption. Because the estate tax return filed for the year of death currently includes an add-back for any earlier taxable gifts, the open question is whether the benefits of the earlier larger gift exemption would be denied in computing the estate tax for the year of death. The practitioner community would expect that Congress would not allow retroactive denial of a benefit that was available at the time the gift was made, but we unfortunately will need to await further legislation or guidance to clarify this issue.

Dynasty Trust. If considering the Dynasty Trust mentioned earlier, there are states that have updated their local law to enable such trusts to continue for several generations or in perpetuity (the "Rule Against Perpetuities"). Because of the longevity, it is important to have provisions in the trust providing guidelines as to the types of expenditures that should be considered, and clear directions regarding trustee succession and retention of advisors. Keep in mind that a husband and wife can put $10 Million in such a trust on a combined basis. With the future appreciation that will occur under the guidance of expert advice from advisors such as Sage Hill, there can be substantial estate tax savings from the length of time the assets remain in trust. Even with the potential clawback discussed earlier, the benefits may greatly exceed the ultimate tax cost, and your advisors can help illustrate how this is analyzed.

Grantor Retained Annuity Trust. Another frequently used transfer tax vehicle is a Grantor Retained Annuity Trust ("GRAT"). In general terms, this is an irrevocable trust that is established during lifetime, structured to provide an annuity stream to the grantor for a period of years, with the remainder to be distributed or retained in trust for the benefit of family members, with the tax advantage that you reduce the value of the discounted remainder interest by the amount of the retained annuity interest. With a large enough annuity stream, we in many cases achieve a "zeroed-out GRAT" which has little or no gift tax value at the time it is funded. It is important to make sure the assets used to fund the trust will be appropriate and adequate to fund the annuity stream that is built-in to the trust provisions. Your advisors can also provide options for how the annuity payout will be structured and paid. As with the transfer tax law, there has been some discussion about restricting the use of this technique for transfer tax purposes. On three different occasions during 2010, the U.S. House of Representatives passed legislation that would require GRAT's to have a ten-year term and a gift tax value at the time of funding that is greater than zero. Although this legislation did not pass in the Senate, it is expected to be addressed again as part of the tax reform efforts targeted at the budget deficit challenge.

Charitable Trusts. For those who are philanthropically inclined, and who would like to retain an interest in the assets for a period of time or lifetime, you may wish to consider a Charitable Remainder Trust ("CRT"). Alternatively, if you are considering tax-effective transfers of wealth to beneficiaries, you may look at the option of a Charitable Lead Annuity Trust ("CLAT"). With both options, you are establishing an irrevocable trust either during lifetime or at death that will eventually transfer wealth to charities (which could include a family foundation) and should be considered carefully with your financial advisor to ensure that it works consistently with your financial, retirement, and legacy planning needs.

Charitable Remainder Trust. A Charitable Remainder Trust ("CRT") is an irrevocable trust which provides an annual payout to designated beneficiaries (typically the grantors who are establishing the trust) for a period of time (up to 20 years) or for their lifetime. At the end of the payout term, the remainder in the trust is distributed to charities (e.g., family foundation) of your choice. Flexibility can be built into the arrangement, such as providing the option during lifetime to change the charitable beneficiaries. The donor receives a charitable income tax deduction for the present value of the charitable interest in the year that assets are transferred into the trust, there is no immediate capital gains tax recognition for appreciated assets that are transferred into the trust, and the annual payouts continue to provide a financial benefit to the recipients.

Charitable Lead Annuity Trust. A Charitable Lead Annuity Trust ("CLAT") is structured to provide an annual payout to charitable beneficiaries, with the remainder interest transferred to your designated beneficiaries at the end of the payout. As with the GRAT, the main benefit is the discounted value of the transfer to beneficiaries several years in the future. Depending on the structure of the trust (determined with advice from your advisor), you may or may not receive an income tax deduction for the charitable interest. In many cases, the trust itself will receive an income tax deduction each year for the amount of income paid out to the charitable beneficiaries. If it is intended that the remainder will pass to second generation or younger beneficiaries, you may also utilize the GST exemption planning that is available when considering the structure of the trust.

Lifetime Credit Trusts. A hot topic amongst estate planners with the available benefits in the transfer tax system is the establishment of lifetime Credit Shelter Trusts for the benefit of the spouse and/or descendents. Normally, such trusts are funded upon the death of the first spouse in order to preserve the benefits of the estate tax exemption available in the year of death. The lifetime Credit Shelter Trust might be an alternative that keeps the entire estate accessible to the spouses, but provides certainty (subject to the claw-back issue discussed earlier) that the $5 Million exemption will be fully utilized. In general, the concept is to have each spouse make a $5 Million irrevocable gift into a trust, which is structured to provide benefits to the spouse and/or descendents after it is established. The plan then is to have the other spouse set up a similar trust so that we now have two irrevocable trusts each with $5 Million of assets funded in 2011 or 2012. Typically, the spouse can serve as trustee, and can be one of the discretionary beneficiaries, with appropriate trust provisions to keep the assets out of the beneficiary-spouse's estate upon death. You can also provide further flexibility by giving the surviving spouse a"limited power of appointment" which gives them

authorization to reallocate how the assets will be distributed upon their death. One caveat is the "Reciprocal Trust Doctrine" which generally states that if both trusts are substantially identical and interrelated, the trust can be ignored for estate tax purposes and each trust ends up being taxable in the estate of the original grantor. With appropriate counsel, the trusts can be established to avoid this doctrine, usually through creation and funding at different times, different benefits for each spouse, or other provisions that would avoid treatment as substantially identical.

Portability. In the 2010 Act, the concept of "portability" has been introduced, which allows the deceased spouse's estate to transfer any unused estate tax exemption to the surviving spouse. It requires the first estate to file a federal estate tax return, Form 706, even though the taxable estate may be less than the exemption amount and a return would not otherwise be required. At this time, it is uncertain whether portability will remain available for decedents who die after December 31, 2012, and therefore, it is dangerous to rely on this technique in the current environment.

Life Insurance. With your team of advisors, you may consider enhancements to your life insurance planning, taking advantage of the additional transfer tax exclusions that are currently available. It can also be an ideal time to transfer individually-owned policies that have grown in value over the years. In many cases we will consider transfers of the ownership to the intended beneficiaries, or alternatively to an independent trustee through an Irrevocable Life Insurance Trust ("ILIT"). Typically we will utilize the annual gift tax exclusion as much as possible to fund the premiums, and apply the increased gift and estate tax exemption to any excess value. If you have an existing insurance trust, you may look at taking advantage of the increased exemption to restructure the trust, create a new trust, purchase a policy from the old trust, or extend or pay off loans at the current low interest rates available.

Conclusion. There are other techniques that are available and may be more appropriate for your particular situation. Again, this is where your advisors such as Sage Hill can provide you options and an analysis of the costs and benefits of each. Other techniques might include forgiveness or extension of loans to family members, sales of assets to grantor trusts in order to "freeze" the value for transfer tax purposes, or personal residence trusts intended to transfer a first or second residence (and sometimes a third) at discounted present values. Many of these techniques have been discussed in prior editions of this newsletter, and many links are available on the Sage Hill website to locate additional information regarding these options. Tremendous opportunity and incentive has been provided to business owners and families with concentrated wealth who wish to consider tax-

efficient methods for transferring wealth and coordinating your business succession planning with the family legacy.

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Business Succession Planning Issues Checklist

When planning the succession of a business, whether family-owned or not, there are many issues to consider that are similar to the physical, financial, and emotional investment to establish and grow the business. You would like this to continue in an orderly fashion regardless of future events. Part of working with an attorney is to make sure that you have the processes and documents in place to handle this transition. Ideally, when talking about business succession, we would like to see a business plan, strategic plan, succession plan, estate plan and disengagement plan.

Why Is Business Succession Planning Important?

1. 95% of American businesses are family-owned.
   a. Family-owned American businesses generate 40% of the Gross National Product.

   b. 35% of the 500 largest companies in the U.S. are family-owned.

   c. Only 28% of family-owned businesses have a succession plan.

2. Only 57% of owners of family-controlled businesses intend to transfer the business to family members.

3. Only 30% of family businesses survive into the second generation.

4. More than 50% of the business owners have more than half of their wealth tied up in their business.

5. One-third of family business owners are 61 or older.

6. 71% of business owners over age 65 indicated that they would continue working indefinitely.

7. 33% of all 35 year olds will be disabled for 90 days or more before reaching age 65.

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Business Succession Checklist

1. Have you defined your personal goals and vision for the transfer of ownership and management?

2. Is your successor identified, ready, and in place?

3. What is the importance of family involvement in leadership and ownership of the company?

4. Are you currently using techniques to mitigate or eliminate estate taxes?

5. Do you have enough liquidity to avoid the forced sale of your business?

6. Do you have a buy/sell agreement in place?

7. Have you had your business valued recently?

8. Do you have a contingency plan should you become disabled?

9. Have you considered alternative corporate structures or stock transfer techniques to help you achieve your succession goals?

10. Are you dependent upon your business to meet your retirement cash flow needs?

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<u>Family Business Issues</u>

Some issues to consider when developing the family business succession plan:

1. Conflict between the departing owner (or his/her heirs) and the remaining owners over management of the company, control and/or money.

2. Friction between new management and heirs looking to participate in the business:

    - What incentives will work to keep key people?
    - Will heirs be forced to liquidate or sell to outsiders?
    - How will you retain income from the business or are there sufficient assets producing enough income to allow the business income to be used in funding the transfer?
    - If the business is gifted only to children active in the business, will there be an unequal estate distribution between those children and those who are not active in the business?
    - Will installment payment impose too much of a burden on the company, especially when expressed in terms of the sales required to generate the after-taxed profits necessary for the principal?
    - Will the surviving spouse's financial security be held hostage to the children's ability to continue the payments after the principal's death?
    - If the business owner dies prematurely, is the stock retained by the surviving spouse?
    - What will the source of income be for the surviving spouse?
    - Will conflicts arise between the children and the senior generation?