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Estate Planning In A Reduced Rate Environment

Financial Executives International

Northeastern Wisconsin Chapter

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Speakers

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Agenda

1 Entity Structuring in the Context of Estate Planning

2 Estate Planning Overview

3 Planning Considerations

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Entity Structuring in the Context of Estate Planning

A new law . . .

- Significant increased compliance burden for many companies
    - New pass-through deduction (199A)
    - Capital intensive companies (bonus depreciation)
    - Heavily leveraged companies (163(j))
    - Companies with foreign operations (GILTI, BEAT)
- Opportunity to reassess current plans and structures
    - Rate decrease for C corporations
    - Increased gift and estate lifetime exclusion
- Changes to individual filers meant to simplify process

Is it time to restructure?

- Under both the old and new law C corporations and pass-through entities (and their owners) have always been taxed differently.
- The new law expanded the difference, leading to potentially significant cash flow savings on income taxes.
- The law provided expanded opportunities for S corporation conversion in certain circumstances.

Income Tax Rate World

Comparison of FEDERAL *top* tax rates			
Type of income	2017	2018/2019	Difference
C corporation	35%	21%	-14%
Individual non-business income			
• Earned income	43.4%	40.8%	-2.6%
• Capital gains and dividends	23.8%	23.8%	------%
• Interest, rents, royalties	43.4%	40.8%	-2.6%
Individual pass-through income			
• Active business not subject to SE tax	39.6%	29.6%	-10.0%
• Active business subject to SE tax	43.4%	33.4%	-10.0%
• Passive income	43.4%	33.4%	-10.0%
Includes 3.8% Medicare tax on investment income and combined employer and employee Medicare rate on earned otherwise limited.			

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Entity rate comparison

FEDERAL and STATE Rate entity comparison—Resident Rate		
Type of business income	2017 Combined rate	2019 Combined rate
• **Pass-through: Active**	45.3%	37.25%
• **Pass-through: Passive**	49.12%	41.05%
• **C corporation: Distribute all earnings**	56.94%	49.09%
• **C corporation: Distribute ½ of earnings**	47.92%	37.42%
• **C corporation: Retain all earnings**	38.9%	25.75%

- *Includes 3.8% Medicare tax on investment income, but not FICA or SE tax on earned income*
- *Assumes AAA has been used post C conversion*
- *Assumes 20% deduction not otherwise limited and tax distr at assumed resident state rate of 7.65%*
- *Assumes C Corp gets deduction for state income tax and PTEs do not*
- *Also assumes 3% PEASE limitation eliminated*
- *7.65% resident state rate for PTEs*

S-Corp to C-Corp Conversion Considerations

- Distributions
    - What is your current discretionary distribution policy?
    - Can your discretionary distribution policy be adjusted or is it limited by bank covenants or other external restrictions?
    - What is the expected rate of distributions if structured as a C-corporation?
- AAA
    - Does the company have the ability to distribute all AAA currently?
    - If not, what is the company's willingness to finance AAA distributions?
    - What effect does a full redemption of AAA have on the financial statements?
    - What effect does a full redemption of AAA have on bank covenants or other external restrictions?

S-Corp to C-Corp Conversion Considerations

- Future transactions
  - Is there a sale of all or a substantial portion of the business contemplated in the next 10 years?
  - Are there current succession plans currently including planned redemptions by shareholders?
  - What are the company cash needs for planned or unplanned redemptions by shareholders?
- Other practical considerations
  - Will all the owners agree?
  - What changes to the law should be considered?

S-Corp to C-Corp Conversion Considerations

- Estate Planning
  - In general, estate planning is more tax efficient for profitable companies when organized as an S-corporation.
  - How is the current shareholder group planning to fund their estate tax?
    - Company funded stock redemptions
    - Shareholder cross-purchase agreement
    - Life insurance
    - Other liquid assets
    - Unknown
  - Are there current estate planning strategies in place that require the use of distributions from the company to achieve shareholder objectives?

What have we seen?

- Despite the cash flow benefit from the rate difference many companies have not made the conversion.
- Why?
  - AAA distribution cash flow considerations.
  - Limited by external stakeholders related to effect on financial statements.
  - Projected tax losses driven by capital asset expense provisions.
  - Current discretionary distribution policy would create significant double taxation if converted to C-corporation.
  - Political uncertainty.
  - Current estate planning requires non-taxable distributions to fund past and contemplated transactions.

What have we seen?

- What have companies done instead of converting?
  - One time significant AAA distribution.
    - Led to: new family offices, private foundations or other outside investments.
  - Increased current discretionary distribution policy.
  - Reexamined shareholder agreements including permitted transferees.
  - Reexamined estate plan in conjunction with discretionary distributions (one-time or annuity).

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Estate Planning Overview

The Premise Of Estate Planning

- There are four things you can do with money:
  - Spend it
  - Give it away
  - Give 40% of it to the U.S. Treasury
  - Aggressively utilize estate planning to maximize assets passed to future generations

The Premise Of Estate Planning – continued

In other words, estate taxes can be handled four ways (MEPS):

A. **Mitigate**: minimizing the tax by reducing the gross estate
B. **Eliminate:** eliminate the tax by spending or giving assets away
C. **Postpone:** delay tax payment through use of marital deduction
D. **Satisfy:** pay taxes, possibly using extension methods

Estate, Gift, and GST Taxes

- Exemption adjusted for inflation (sunsets 2025) and 40% rate

- Estate tax exemption portability

Exemptions and rates for estate, gift, and GST					
	2009	**2010-2011**	**2012-2013**	**2014-2017**	**2018-2019**
Exemption	$3.5m	$5m*	$5.12m 5.25	$5.34m 5.49m	$11.2m- $11.4m
Rate	45%	35%	35% 40%	40%	40%

Common Estate Planning Objectives

- Identify who gets what, when and under what circumstances
- To name fiduciaries to administer assets and make various decisions
- To avoid probate (post death) and guardianship (during life)
- Asset protection
- Income and Estate tax minimization
- Business succession planning:
  - ownership succession
  - control succession

Shareholder Best Practices For Ownership Succession

- Develop and maintain mindset of *stewardship* with an understanding that a failure to plan or a lack of coordination of plans negatively impacts:
  - family members
  - other shareholders
  - company
  - employees
  - local community

Shareholder Best Practices For Ownership Succession – continued

- Develop baseline "testamentary" plan for clarity and transparency (i.e. Will, Trust, ILITs, etc.)
  - articulate plan to interested persons
  - Note: testamentary plan will not solve economic, tax efficiency, or liquidity issues
- Develop and implement "lifetime" plan for tax efficiency and liquidity purposes

Guiding Principles
Ownership Succession

- Continue above average earnings and free cash flow

- Maintain cash flow to Shareholders to provide for economic needs and lifestyle

- Prudent use of capital and tax efficiency

- Perpetuation of Company as privately held and locally owned and controlled

Primary Objectives Ownership Succession

- Meet shareholders' desire for liquidity during life and in event of death
- Align Company's risk management strategy and financing plans with shareholders' needs while protecting on-going well being of enterprise Prudent use of capital and tax efficiency
- Company legal/operating structure that is conducive to new capital investment, shareholder liquidity
- Develop strategic plan and operating initiatives that support principles and objectives

Testamentary Tax Planning

- Application of the federal and state Estate and Generation Skipping Tax
  - Tax on FMV of Property at DOD or AVD
    - impact of "control" on value/focus on what is owned
  - Income tax "basis" step up
  - Marital Deduction/Charitable deductions
  - Exemption amounts/Portability
  - A/B Plan
  - Non-charitable testamentary plan does not eliminate tax; merely defers it
    - "tax inclusive" nature of estate tax
    - 6166 deferral for family business interests
    - Impact on Company/follow ownership/control
    - coordinate with Buy Sell agreement
    - Consider higher exemption and tax basis increase versus tax obligation

Lifetime Transfer Tax Planning

- Application of the federal and state Estate and Generation Skipping Tax
  - Tax on FMV of Property at Date of transfer
    - focus on what is "transferred" -- different perspective
  - Income tax "basis" carryover
  - Marital Deduction/Charitable deductions
  - Exemption amounts/Portability
  - Annual Exclusion amount--$15,000
  - Lifetime transfers have ability to permanently avoid tax
    - "tax exclusive" nature of gift tax
    - valuation discounts for lack of control and marketability of family business interests
    - Impact on Company

Lifetime Transfer Tax Planning – continued

- Strategies
  - use annual exclusion
  - early use of exemption
    - leverage through valuation discounts
    - subsequent appreciation escapes future taxation
  - Non-voting shares avoid impact of lifetime transfers on control of company
  - Taxable gifts and pay gift tax (versus estate tax)
    - $1 Million:
      - Estate Tax: $400k tax; $600k inheritance (i.e. 67% eff rate)
      - Gift tax: $285k tax; $715k inheritance (i.e. 40% eff rate, subject to 3 year rule)
  - "Freeze" strategies: (GRAT, IDGT sale); affirmative use of grantor trust rules
  - Balance foregoing with higher exemption and tax basis increase

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Planning Considerations

Planning Considerations

- Estate Tax Funding
    - Company funded stock redemptions
        - Can the company afford?
            - Consider life expectancy and untimely deaths
    - Shareholder cross-purchase
        - Typically funded through life insurance and can be cost prohibitive for high growth companies
    - Other liquid assets

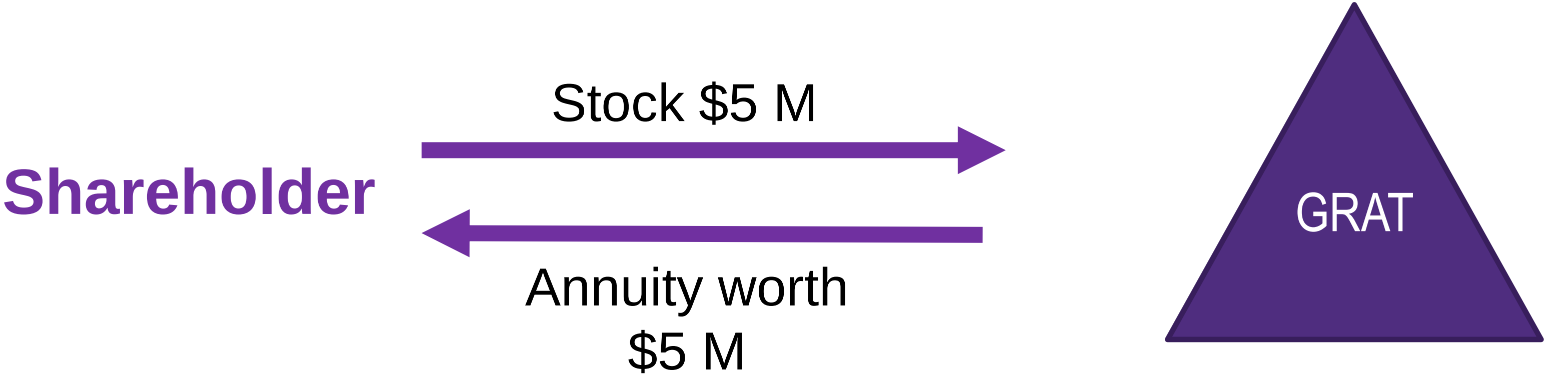
Planning Considerations

- Alternatives
  - Sale to Intentionally Defective Trust
  - Grantor Retained Annuity Trust

Grantor Retained Annuity Trust

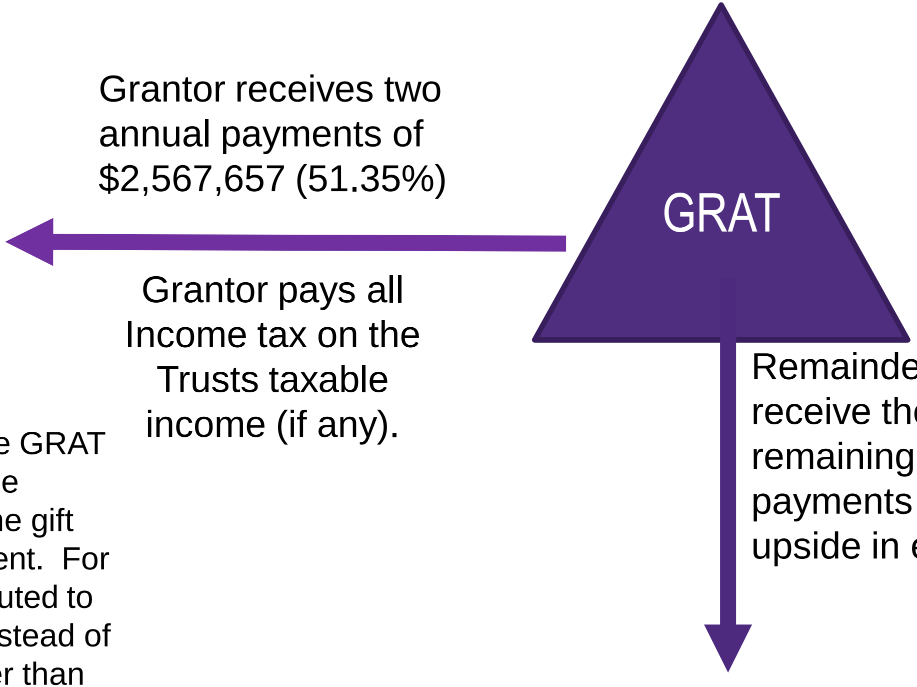
- A grantor retained annuity trust (GRAT) is an irrevocable trust into which the grantor places assets and retains an annuity for a term of years
  - At the end of the trust term, the trust assets may remain in trust for the benefit of or pass directly to the beneficiary (usually children)
  - Grantor must survive the GRAT term or all assets are taxed in his/her estate
  - The lower the 7520 rate, and the higher the asset growth/income – the better the gift tax savings result from the GRAT Strategy

Step 1: Shareholder Gifts Stock to GRAT


Stock $5 M
Shareholder
GRAT
Annuity worth
$5 M

Example:
The value of the Taxable Gift of the remainder interest is only $.55. Assuming a 51.35% 2 year annuity and a 1.8% Section 7520 rate.

Step 2: GRAT Operations



GRAT

Shareholder

Grantor receives two annual payments of $2,567,657 (51.35%)

Grantor pays all Income tax on the Trusts taxable income (if any).

Remainder Beneficiaries receive the assets remaining after the annuity payments are made (i.e. all upside in excess of 1.8%).

Beneficiaries
(e.g., children, etc.)

If the value of the assets contributed to the GRAT are successfully challenged by the IRS, the annuity self adjusts to virtually eliminate the gift tax exposure of an IRS valuation adjustment. For example, if the value of the assets contributed to the GRAT were determined to be $10M instead of $5M, the taxable gift would be $1.10 rather than $.55.

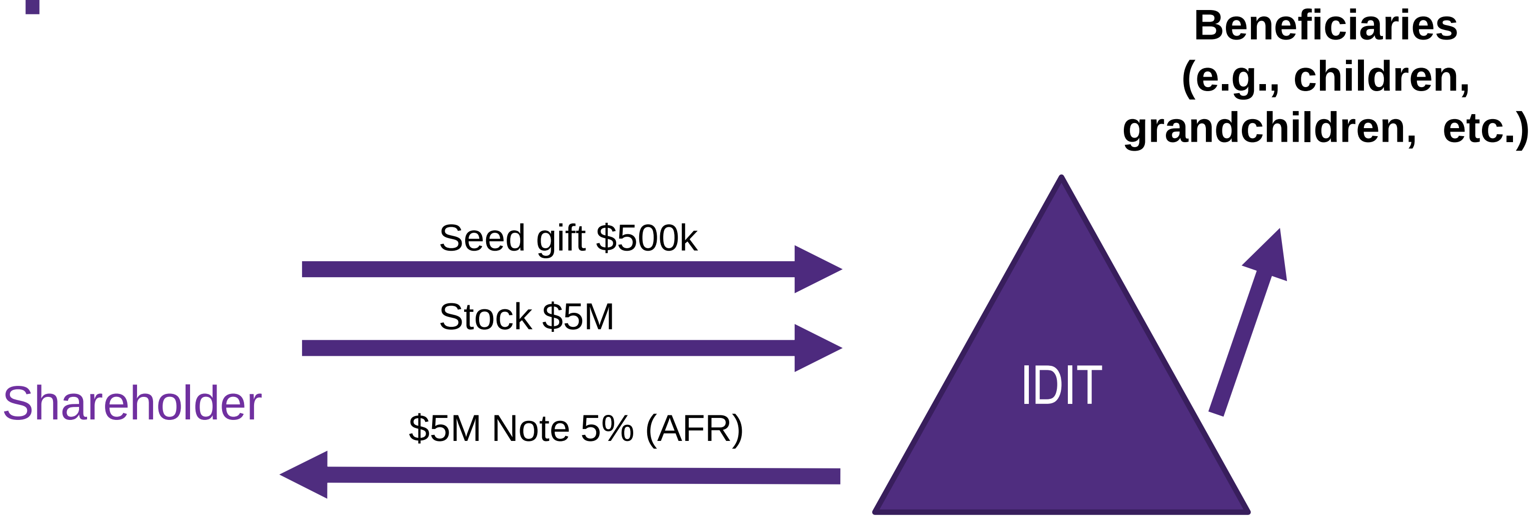
Intentionally Defective Irrevocable Trust (IDIT)

- Intentionally defective irrevocable trust (IDIT)
  - Technique takes advantage of disparity between income and estate tax laws
  - Sale of a low value/high growth potential assets to an irrevocable trust for an interest-bearing note
  - “Seed” money of 10% is required for the sale
  - Gift return should be filed to disclose transaction and start the statute of limitations
  - Income tax paid by grantor not considered a taxable gift

Intentionally Defective Irrevocable Trust (IDIT) – continued

- The IDIT can accomplish similar results as a GRAT but can be protected from the GST Tax and therefore is a superior multi-generation planning vehicle
- With regard to early death risk, the IDIT is superior to the GRAT
- An IDIT has a lower required interest rate and therefore can provide a slightly better estate value freeze than a GRAT
- However, a GRAT has superior valuation risk protection than an IDIT can provide. If you are wrong on your valuation with an IDIT you may have a taxable gift to the extent you were wrong.

Step 1: Shareholder Sells Stock to IDIT


Beneficiaries (e.g., children, grandchildren, etc.)

Seed gift $500k

Stock $5M

Shareholder

$5M Note 5% (AFR)

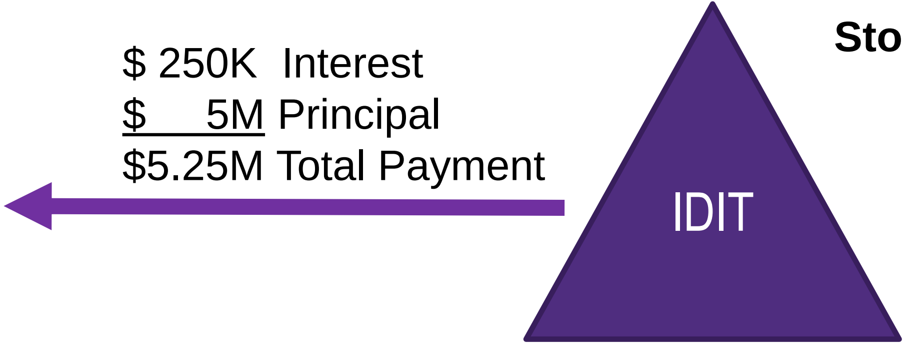
IDIT

Step 1: Outcomes

- Taxable gift of $500k; 709 reporting (Gift and GST)
- No gain is triggered on sale for income tax purposes
- Asset sold is excluded from estate since the transfer is respected for estate tax purposes
- There is no gift on sale since the IDIT provides adequate consideration in the form of a note
- A tax free freeze is accomplished

Step 2: IDIT Repays Note With Cash After The Event

After Event,
Stock worth $12M



$ 250K Interest
$ 5M Principal
$5.25M Total Payment

Uses cash from stock sales
After Event to repay note

Questions

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