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Estate Planning for Small Business Owners

HOSTED BY OCEAN FIRST BANK

PRESENTED BY MONZO CATANESE HILLEGASS, P.C.

SPEAKER: DANIEL S. REEVES, ESQUIRE

Topics

- Tax Overview
- Trust Ownership
 - Intentionally Defective Grantor Trusts
 - Grantor Retained Annuity Trusts
- Installment Sales
- Gifting Strategies
- Asset Protection Planning

Federal Taxes

Federal Estate and Gift Tax

- Unified Tax
- Total Lifetime Exemption: \$5.49 Million
 - Adjusted annually for inflation
- Rate: 40%
- Unlimited marital deduction
- Portability
- Gross estate determined by IRC 2031-2046

Federal Capital Gains Tax

- Rate: 15% to 20%
- If assets are gifted during life, recipient takes with transferred basis
- If assets pass at death, beneficiary receives step-up in basis to current market value



New Jersey Taxes

New Jersey Estate Tax

- 2017 Lifetime Exemption: \$2,000,000
- Unlimited marital deduction
- No portability
- January 1, 2018: estate tax repealed

New Jersey Inheritance Tax

- Rate depends on class of beneficiary
- Class A: No tax
 - Spouse, Children (natural, adopted, and step-children), Descendants, Parents, Grandparents
- Class C: First \$25,000 exempt, then 11% to 16%
 - Siblings, Sons- and Daughters-in-law
- Class D: 15% to 16%
 - All other beneficiaries
- Class E: No tax
 - Charitable organizations



Irrevocable Trusts, Generally

- Grantor completely surrenders benefit and enjoyment of assets
- Grantor can maintain some indirect control over assets through trust terms
 - Select trustee
 - Specify when and to whom distributions may be made
 - Provide spendthrift protection
- No basis step-up at death

Irrevocable Trusts, Generally

- Grantor transfers assets to trust by sale or gift
- Assets can appreciate outside of estate if properly structured
- If assets are transferred for fair value or grantor uses lifetime exemption, trust corpus will be excluded from grantor's estate

Irrevocable Trusts: Provisions to Avoid

- Must avoid any powers that cause assets to be included in estate
 - Retaining possession and enjoyment or right to control beneficial enjoyment of assets (IRC 2036)
 - Includes right to vote shares of transferred stock
 - Retaining right to alter, amend, revoke, or terminate trust (IRC 2038)
 - Retaining power of appointment (IRC 2041)

Grantor Trusts

- Trust income is taxed to grantor
- Transactions between grantor and trust are disregarded for income tax purposes
 - No capital gain on transfer of stock
 - No ordinary income on payment of interest
- Can be revocable or irrevocable
- Can be included in or excluded from grantor's estate, depending on provisions

Grantor Trusts: Provisions to Include

- Must include a power that causes income to be taxed to grantor
 - IRC 673-679; some are “safe”, some trigger estate inclusion, and some are questionable
 - Most commonly included powers:
 - Power for trustee to add charitable beneficiaries (IRC 674)
 - Power to make loans to grantor without adequate security (IRC 675(2))
 - Power to substitute trust assets with assets of equal value (IRC 675(4))
 - Power to use income to pay life insurance premiums for grantor or grantor’s spouse (IRC 677(a)(3))

Grantor Trust: Power to substitute assets

- Most common income inclusion mechanism
- Governed by IRC 675(4)(C)
- Substituted assets must have equal value
- Power must be exercisable by any person in a non-fiduciary capacity without requiring approval of a fiduciary
 - Non-fiduciary capacity: not exercisable primarily in the interests of the beneficiaries
 - Determined using a facts and circumstances test
 - If power is held by trustee, the power is presumed to be held in fiduciary capacity

Grantor Trust: Power to substitute assets

- Revenue Ruling 2008-22: power does not cause estate inclusion under IRC 2036 or IRC 2038 as long as two requirements are met:
 - 1.) The trustee has a fiduciary obligation (under trust instrument or local law) to ensure that the grantor complies with the terms of the trust by ensuring that value of assets is equivalent
 - 2.) Exercise of power cannot be used to shift benefits among beneficiaries
 - A. Satisfied if trustee has power (under trust instrument or local law) to reinvest trust corpus, together with a duty of impartiality with respect to beneficiaries
 - B. Satisfied if the nature of trust investments or the level of income produced by any or all of the trust investments does not impact the respective interests of the beneficiaries,
 - Trust is administered as a unitrust (under trust instrument or local law)
 - Distributions are limited to discretionary distributions of principal and income

Grantor Trust: Power to substitute assets

- Some practitioners argue that Rev. Rul. 85-13 provides ability for grantor to substitute low basis assets with high basis assets to take advantage of step-up in basis at death
 - Unfortunately, this view may not be justified
 - There are no cases addressing this approach and few practitioners actually seem to attempt to take advantage of it
 - Not consistent with treatment in analogous situations involving QPRTs or 1031 exchanges
 - Despite potential obstacles, it is possible that this position could be accepted by the IRS, which would permit significant capital gains savings

Intentionally Defective Grantor Trust (IDGT)

- Irrevocable grantor trust excluded from grantor's estate
- "Defective" because trust is treated as being owned by grantor for income tax purposes
- Grantor gifts 10% of the value of an asset to the IDGT, then sells the remaining interest to the IDGT using installment sale method
- Assets appreciate outside of grantor's estate while grantor's estate is reduced by payment of income tax, resulting in larger transfer to beneficiaries
- Essentially permits gift-tax-free gifts to trust by paying the income tax attributable to the trust income

Grantor Retained Annuity Trust (GRAT)

- Irrevocable grantor trust
- Grantor transfers property to trust while reserving the right to receive annuity payments at a stated rate for a designated period of time (the initial period)
 - Payments can be fixed or can increase by up to 20% annually
 - Grantor cannot contribute additional assets to trust after formation
- The transfer is divided into a present interest and a remainder interest
- The value of the remainder is determined at the time of the transfer based on the applicable Federal Rate (IRC 7520 rate)
- Only the remainder is a taxable gift; this permits grantor to transfer assets to beneficiaries at lower value

Grantor Retained Annuity Trust (GRAT)

- If grantor survives the initial period, the remainder interest will not be included in grantor's estate
- If grantor dies during initial period, the entire trust amount will be included in grantor's estate
- Upon expiration of initial period, trust may distribute assets to beneficiaries or maintain in trust

Valuation Discounts

- Can take discount on value of business
 - Lack of marketability: impossible or harder to sell
 - Lack of control: non-existent or minimal voting power
- Discount is based on the fact that the interest would not sell for full price on the open market
- Discount should be determined by accountant using standard valuation principles
- Common to take total discounts of 35% to 40%
- Future of valuation discounts for family businesses is uncertain

Installment Sales

- Sale of property with payments made over multiple years
- Buyer provides seller with an interest-bearing note, generally using the applicable Federal Rate, which applies from the date of the note
- If the seller dies before the note is paid off, the note is included in the seller's estate
- Each payment is broken down into categories, pro rata:
 - 1.) return of capital: not taxable to seller, not deductible by buyer
 - 2.) capital gain: taxable to seller, deductible by buyer
 - 3.) interest: ordinary income to seller, may be deductible by buyer

Installment Sales: Deferred Tax

- Tax is deferred until payments are received
- IRS will charge interest on deferred tax if the purchase price exceeds \$150,000 and total outstanding installment sale balances exceed \$5,000,000 (IRC 453A)
 - Deductible by corporations
 - Not deductible by non-corporate taxpayers, including owners of pass-through entities
- Can effectively double \$5M limit by first gifting to spouse

Installment Sales: Calculation of Deferred Tax

- Installment note obligation: \$50M
- Applicable percentage: 90% ($(\$50M - \$45M) / \$50M$)
- Deferred tax: \$10M ($\$50M \times 20\%$)
- Applicable percentage of deferred tax: \$9M ($90\% \times \$10M$)
- Underpayment penalty rate: 4%
- IRC 453A interest charge (Year 1): \$360,000 ($\$9M \times 4\%$)

Installment Sale to IDGT

- Sale is disregarded for income tax purposes, so no capital gain (Rev. Rul. 85-13)
- Removes future appreciation from grantor's estate
- Payment of taxes by grantor reduces grantor's estate and allows asset to grow faster
- Asset should produce sufficient income to pay interest and accumulate gains
- Benefits can be increased by using an interest-only note with a balloon payment
- Interest payments to grantor are not taxable because it is a grantor trust
- Deferred tax penalty does not apply

Installment Sale to IDGT: Requirements

- 1. Interest rate must meet or exceed Applicable Federal Rate
- 2. IDGT must possess some assets before sale (“seed money”)
 - Can make a gift to the trust before the sale (common to use 10% of price), which will use a portion of the lifetime exemption
 - Some practitioners prefer to use liquid assets to help cover early payments while trust earns income
- 3. Value of business should be reasonable and substantiated
 - Failure to sell at full price may result in deemed gift of remaining value
 - Can take valuation discounts

Installment Sale to IDGT: Example

- Business valued at \$30M; Discounted value of \$20M
- Make seed gift of \$2M in liquid assets to IDGT
- Installment sale with 15-year interest-only note at 2% with final balloon payment (on \$20M)
- Business makes profit distributions of \$1.5M per year
- IDGT pays \$400,000 in interest to grantor annually (not taxable to grantor)
- Grantor pays income tax on \$1.5M distributed by business (\$594,000)
- Business grows to \$21M after Year 1; total value is \$22.1M after profit distribution less interest payment
- Results in a \$2M shift to the trust; Estate tax savings: \$800,000 in Year 1

Self-Cancelling Installment Note (SCIN)

- Similar to standard installment sale, but note obligation terminates when grantor dies
- Removes remaining balance of note from estate if grantor dies prematurely
- Requirements
 - 1. Buyer must pay a higher interest rate or sale price to account for risk of early termination (“risk premium”)
 - 2. Grantor must be in reasonably good health to justify valuation
- If grantor survives until entire balance is paid, no benefit accrues; transaction becomes a standard installment sale with a higher rate of interest
- If grantor dies prematurely, the cancellation of the note is taxed as a disposition and the full value of unpaid gain is taxed at the capital gains rate

Gifts Considerations

- Annual federal gift tax exclusion: \$14,000 per person
- No New Jersey gift tax
- Useful for avoiding New Jersey inheritance tax and estate tax
 - Three year look-back period
- Can transfer assets directly to beneficiaries or to a trust
- Can use with a variety of assets
- Assets pass with transferred basis

Gifting Strategies

- Annual gifting: can give \$14,000 per year every year to any number of individuals
 - Gifts in trust qualify for the annual exclusion if they convey an unrestricted present interest in property (can satisfy with Crummey withdrawal power)
- Gift splitting: married couples can combine their annual exclusions to double the value of a gift
- Make gifts at low value: enables you to minimize value of gift for estate and gift tax purposes while asset appreciates in the hands of the beneficiary
 - Beneficiary may be a trust
- Ability to value at lower amount through valuation discounts (lack of marketability and lack of control)

Giftting Strategies

- Gift property to a GRAT
- Make use of sequential or cascading GRATs: each year, all of the income from all prior GRATs is used to fund a new GRAT
 - If grantor survives, initial gift and all income is shielded from gift tax
- Create a GRAT with a high annual payout to “zero out” the value of the gift to the GRAT

Gift Strategies: Charitable Giving

- Make gift of appreciated property
 - Transfer asset directly rather than selling first to pass more to charity and avoid capital gain
 - Take current income tax deduction for charitable gift for lower effective cost of gift (save up to 39.6% on value of gift)
- Use Charitable Remainder Trust (CRT)
 - Grantor makes gift to irrevocable trust that pays income stream to grantor or another beneficiary for a set period of time
 - Upon expiration of the period, the remainder passes to the designated charity
 - Provides grantor with immediate deduction based on future value of charitable remainder
 - Income beneficiary pays income tax on distributions

Gift to GRAT with No Gift Tax: Example

- Assume grantor has stock portfolio worth \$1M and assume no dividends are paid and stock will grow at 10%
- June 2017 applicable Federal Rate is 2.4%
- Grantor must receive payments of approximately 52% to zero out value of gift (determined by reference to annuity tables)
- 1st annual distribution: \$520,000
- 2nd annual distribution: \$520,000
- Remaining value in GRAT: \$118,000

Asset Protection Planning

- Goal: Protect assets from potential creditors by maximizing use of exempt assets and creating barriers around non-exempt assets to discourage collection efforts
- Self-settled trusts are disregarded with respect to creditors (N.J.S.A. 25:2-1)
- Transfers made with intent to defraud creditors will be disregarded (N.J.S.A. 25:2-25)
 - Regardless of whether claim arose before or after transfer, a transfer is made
 - a.) with actual intent to hinder, delay, or defraud any creditor OR
 - b.) without receiving reasonably equivalent value in exchange and grantor
 - 1) engaged in business for which remaining assets were unreasonably small or
 - 2) intended to incur debts beyond the debtor's ability to pay

Asset Protection Planning: Exempt Assets

- “Qualifying trusts” exempt from claims of creditors and excluded from estates in bankruptcy (N.J.S.A. 25:2-1)
 - Retirement accounts and college savings plans completely protected
 - Includes 401(k), IRA, and Roth IRA, among others
 - Both principal and distributions are exempt from claims of creditors
 - Consider setting up separate bank account to receive distributions to preserve exempt status
- Life insurance proceeds and avails exempt if paid to a person other than the insured, the person who effected the policy, or the estate of either of them (N.J.S.A. 17B:24-6)
 - Exempt from claims of creditors of insured and person who effected policy
 - Exempt from pre-existing claims against the beneficiary

Asset Protection Planning: Exempt Assets

- Property owned as tenants by the entirety is exempt from claims against only one spouse as long as the non-debtor spouse is alive and is permanently protected if the debtor spouse predeceases the non-debtor spouse (N.J.S.A. 46:3-17.4 and -17.5)
 - Court may order debtor spouse to pay rent for debtor's spouse's use of property owned as tenants by the entirety during debtor spouse's life
- Annuities are exempt, but creditors may reach monthly payments exceeding \$500 per month (N.J.S.A. 17B:24-7)

Asset Protection Planning: Trusts

- A trust beneficiary's creditors may reach the beneficiary's interest if the trust does not contain a spendthrift provision (N.J.S.A. 3B:31-35)
- Assets contained in a spendthrift trust are protected until they are actually received by the beneficiary (N.J.S.A. 3B:31-36)
 - Spendthrift provision must restrain both voluntary and involuntary alienation, but it is sufficient for the trust to provide that the interest is held subject to a "spendthrift trust"
 - Spendthrift provision is valid even if the beneficiary is the trustee
 - A trustee may be able to avoid the claims of creditors by making distributions to the suppliers of goods and services on behalf of the beneficiary, rather than directly to the beneficiary
- Even without a spendthrift provision, a creditor may not compel discretionary distributions, even where there is a standard of distribution, but may compel mandatory distributions that have not been made (N.J.S.A. 3B:31-38 and -40)

Asset Protection Planning: Trusts

- A holder of a power of withdrawal is treated as the grantor of the portion subject to withdrawal during the period when the power may be exercised (N.J.S.A. 3B:31-39)
 - Upon release of the power, the beneficiary is treated as the grantor only to the extent that the value of the property affected by the release exceeds the greater of a.) \$5,000; b.) 5% of the corpus; or c.) the annual gift exclusion
- The assets of a trust are subject to the claims of the grantor's creditors to the full extent of any reserved interest of the grantor in the trust (N.J.S.A. 3B:11-1)
 - Exception: this rule is not triggered by a trustee's discretionary authority to pay income or principal to the grantor to satisfy income taxes owed by the grantor in connection with trust income or principal

Asset Protection Planning: Asset Protection Trust (APT)

- Delaware pioneered a law providing protection against the creditors of a grantor of a self-settled trust and several other states have followed suit (but not New Jersey)
- To create an APT, the grantor must establish an irrevocable spendthrift trust that states it is governed by the law of an APT state and appoint a trustee from the designated state
- Can be established to provide the grantor with mandatory income distributions or discretionary support
- Unfortunately, there is very little case law addressing the question of whether APTs are actually effective at shielding assets from creditors
 - May still act as a deterrent to creditors and encourage them to settle their claims

Asset Protection Planning: APT

- Because New Jersey does not allow the use of self-settled trusts to shield assets from creditors, it is critical to structure the APT to minimize contacts between the APT and New Jersey to reduce the likelihood of a New Jersey court applying New Jersey law to the APT
 - Do not appoint a co-trustee who resides in New Jersey or retain the power to substitute the trustee
 - Do not place New Jersey real estate into the APT
 - If the grantor is entitled to discretionary support from the APT, avoid making frequent requests for distributions to avoid the appearance that the grantor remains in control of the APT assets
 - The grantor should not expect to rely on discretionary distributions from the APT and should only transfer assets to the APT that are not expected to be needed during the grantor's lifetime

Thank You

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