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Advisory & Management

***Saving Estate Tax****….while providing income to support your financial independence, providing a multi-generational platform for functional children & descendants, and protecting well-earned business assets against creditors*

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One of the primary goals of business owners is to reduce estate taxes and provide liquidity for their estate to avoid forced sale of the business upon death. Additionally, when providing for succession or sale, an owner needs to replace their employment and ownership income with other sources.

Life insurance salespeople absolutely love these circumstances. Nothing against life insurance salespeople, but frequently, use of proper techniques will eliminate, or at the least reduce, the need to pay life insurance premiums to enable estate liquidity.

For the last several years, one of the most advantageous strategies which has helped business owners accomplish the goal of reducing estate taxes better has been grantor retained annuity trusts (GRATs). This strategy has been extremely effective particularly because of low interest rates enabling little or no gift tax imposed in the transfer of significant assets. As a result, *once you determined your lifetime income needs*, you could:

- Transfer significant assets with little gift tax;
- Retain income from the trust to support your financial independence;
- By transferring currently, 100% of the value (+ appreciation) can benefit future generations (rather than value + appreciation, minus 35 – 55% estate tax);
- Eliminate the need for life insurance premiums to provide for estate liquidity;
- Create trust provisions which reflect how and when you would like your children, grandchildren, etc to receive your gifted assets

*But*, now that we have told you about all of the wonderful benefits of GRAT's, they may soon be eliminated in many future cases. Changes are afoot in Congress that would significantly restrict the tax advantages of these trusts and put an end to some popular tax reduction strategies they made possible. There is, however, another strategy which offers many similar attributes (i.e. estate tax savings, less life insurance required for estate liquidity, income to the business owner)…Grantor Deemed Ownership Trusts ("GDOT"). These trusts have their own advantages in certain circumstances, and are sometimes even more efficient than GRAT's.

While a sale of a business interest to a GDOT involves slightly greater complexity than a GRAT, it offers potentially greater transfer planning opportunities. A sale to a GDOT generally happens in three steps:

- First, the grantor forms a specially designed grantor trust (the GDOT).
- Second, the grantor makes a taxable gift of cash or marketable assets to capitalize the GDOT (which allows the trust to make the down payment on the sale).
- Third, the grantor sells shares of the business to the GDOT in an installment sale. In exchange for the partnership interest, the grantor receives a down payment and takes back a promissory note from the GDOT.

Additionally, the following T's must be crossed for proper integrity of the strategy:

- The sale must be commercially reasonable to be respected by the IRS so that the agency does not treat it as a gift.
- A qualified valuation professional should be retained to determine the appropriate valuation for the company shares.
- A substantial down payment from the trust back to the grantor is necessary to give the promissory note efficacy— 10% to 20% is often cited, but this is based on speculation, not authority.
- The promissory note from the GDOT is often structured as an interest only note for a term of years with a balloon payment due upon expiration of the term. The interest rate on the note should be equal to the minimum applicable federal rate at the time of the sale. The note should be secured by the shares and/or personal guarantees of the trust beneficiaries. A self-canceling installment note or private annuity can also be used.

As a *grantor trust,* the GDOT is treated *for income tax purposes* as if the trust assets are owned by the grantor (i.e., the grantor, and not the trust, is taxed on the trust's income and capital gains) even though the corpus and income benefit the trust beneficiaries. It is therefore advantageous from a transfer tax perspective to subject the grantor to taxes on the trust's income because the grantor's payment of the trust's taxes essentially allows the grantor to make additional tax-free gifts to the trust with each payment of the trust's tax liabilities, further depleting the grantor's estate…and thus eliminating potential estate tax of 35 – 55% on those dollars.

A GDOT is an *irrevocable* trust… thus it allows the trust assets to be excluded from the grantor's taxable estate. Very, very importantly, the terms of the trust can follow the business owner's goals for the shares of the company which he has worked so hard to create and/or build. When properly and sensitively drafted, the Trust enables longevity of the business and family harmony among one's children….rather than the inverse effect that is caused by poor planning and legal document drafting.

A few final notes regarding the Grantor Deemed Ownership Trusts:

- Grantors must be careful when drafting the trust instrument to achieve the intended tax consequences. Some of the powers that may be included to accomplish the desired results include giving non-fiduciaries (including the grantor) the power to reacquire the trust corpus by substituting other property of an equivalent value, giving the grantor or another eligible party (such as the grantor's spouse) power to borrow from the trust without adequate interest or security, and giving the grantor power to use trust income to pay premiums on life insurance for the grantor or for his or her spouse.
- The IRS' Revenue Ruling 85-13 says, in effect, that a grantor can transfer or sell highly appreciated property to a GDOT without any income tax consequences.

We frequently utilize these Trusts for Sage Hill client families as part of their business succession plan or in advance of the sale of their company. Our holistic thinking positions the GDOT as one of the tools to:

- Reduce estate taxes
- Eliminate / Reduce the cost of life insurance premiums to create estate liquidity
- Create income for the business owner after succession / sale
- Enable functional relationships among your children whether in or outside of the business
- Provide for potential longevity of the family business
- Continue your legacy

Your local tax attorney drafting the agreement must be very sophisticated in estate tax planning. Your legal fee savings, by us bringing to them a thorough, detailed blueprint, are just one of the other benefits of a well-structured, thoughtful, comprehensive plan.