

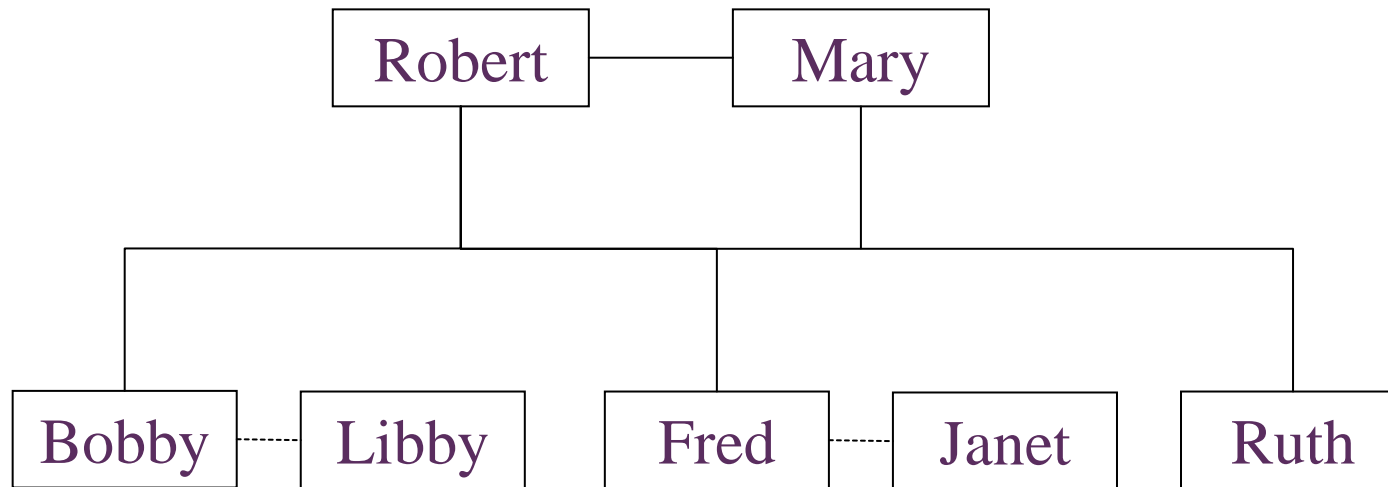
WIGGIN AND DANA



Estate Planning Opportunities for Closely Held Business Owners
A Presentation for the Exit Planning Exchange

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Family Background



Family Background

- Robert considering potential sale
- Bobby is an insider and thinks he's taking over
- Ruth is sort of an insider (part time employee)
- Fred works construction
- All three children have children; one of Fred's children has special needs

Assets

- 100 percent interest in PeopleCo
- Leases business real estate from brother
- \$2 million liquid
- Residence
- Vacation home

Where Do We Start?

- Planner's temptation – show off our entire bag of tricks
- Can lead to “analysis paralysis”
- Take it in phases

Phase One

- Incapacity planning
 - Power of attorney and health care proxy
 - Deferred compensation plan?
 - Disability insurance
- Will and Revocable Trust
 - Exemption capture planning
 - Divorce protection planning
 - Special needs planning for Fred's child
- Buy-Sell Agreement
 - Life insurance funding?

Phase Two

- Advanced testamentary planning
 - Mellinger trust
 - Charitable lid
 - Dangers of bequest of business to foundation
- Gift planning
 - Outright gifts
 - SLAT
 - GRAT
 - IDIT Sale
 - QPRT

Gift Planning Background

- The Airtight Transfer Tax System
- Leaks in the System
 - Freezing values
 - Discounting values
 - Removing values
 - Paying gift tax?

Possible Additional Section 2704 Regulations

- Section 2704 disregards “applicable restrictions” in valuation of gift of interest in family-controlled entities
- An applicable restriction is one that:
 - Limits the ability of the entity to liquidate and
 - Either:
 - The restriction lapses after the transfer or
 - The transferor or members of his/her family can remove the restriction
- Under current law, restrictions imposed by state law are not applicable restrictions

Possible Additional Section 2704 Regulations (Continued)

- Section 2704(b)(4) gives IRS broad authority issue regulations providing that “other restrictions” shall be disregarded
- Concern is that the “state law” exception to applicable restriction definition may be circumscribed by regulation

Spousal Lifetime Access Trust

- Trust with spouse and descendants as beneficiaries
- Funded with:
 - Annual gifts using \$14,000 exclusion
 - Larger gifts using \$5.43 million gift tax exemption
- Benefits
 - Estate reduction
 - Simple to create and administer
 - Continuing access and control for grantor's spouse
 - Grantor trust
 - Generation skipping?

A Zeroed Out GRAT

- Grantor transfers \$1 million to a GRAT when IRS assumed interest rate = 1.2%
- Grantor receives \$118,000 annually for 9 years
- After 9 years, remaining GRAT funds pass to children
- Value of taxable gift is near \$0

Savings Dependent On Investment Performance

**Average Return
for 9 years**

1.2%

4%

6%

8%

**Amount Passing Tax-Free
to Children After 9 Years**

\$0

\$176,000

\$335,000

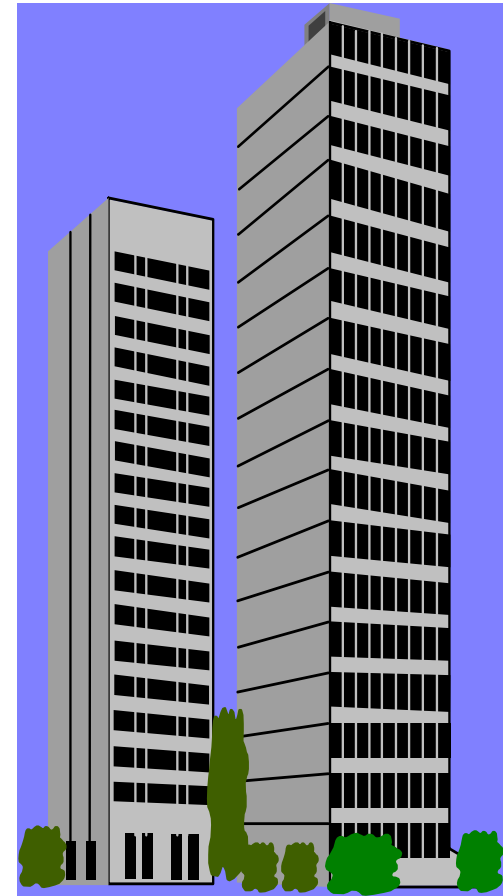
\$527,000



Property Suitable for a GRAT

- Growth stocks
- Commercial real estate
- Closely held business
- LLCs and LPs

Gift tax risk of undervaluation can be minimized



GRAT Risks

- What if grantor dies before termination of GRAT?
 - At worst, property is taxable in grantor's estate
 - Nothing gained, but nothing lost
- What if trust investment performance is less than IRS assumed rate of return?
 - Again, nothing gained, but nothing lost

Sale to an Intentionally Defective Irrevocable Trust (IDIT Sale)

- Grantor Sells Property to Irrevocable Grantor Trust
- Grantor Receives Promissory Note From Trust
- Note Terms
 - Interest Only at Applicable Section 1274 Rate
 - Balloon Payment of Principal at End of Note Term
- Grantor's Interest in Property Frozen at Face Value of Note Plus Annual Interest Payments
- Objective: Outperform Required Interest Rate On Note Under Section 1274

IDIT Sale Example

- Grantor Sells Property Worth \$1,000,000 to “Seeded” Irrevocable Grantor Trust
- Grantor Receives 9-Year Promissory Note From Trust
- Note Terms
 - Interest Only at Applicable Section 1274 Rate (1.07% for this example)
 - Balloon Payment of Principal at End of Note Term

Amount to Children Depends on Investment Performance

Average Return for 9 years

1%

2%

4%

6%

8%

Amount Passing Tax-Free to Children After 9 Years

\$ 0

\$ 86,900

\$297,000

\$542,000

\$828,000

IDIT Sale Risks

- No Safe Harbor Under Code
 - No Automatic Revaluation of Note Upon Audit
 - Will formula work to avoid *Proctor*?
 - *Wandry v. Commr, T.C. Memo 2012-88*
 - Gifts of LLC interests based on defined value formulas
 - Taxpayer assigns “X dollars worth of LLC interests to descendant”
 - Successful use of a “formula provision” as opposed to a “savings provision”
- Sea change or false hope

No Safe Harbor

- Possible Application of Sections 2036 and 2702
- Statute of Limitations
 - Gift tax return - disclosure
- Possible Gain Recognition At Grantor's Death