Business Succession Planning With A Charitable Twist

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Estate Planning Fundamentals

Business Succession Planning With A Charitable Twist

Introduction to Business Succession Planning

A. Tax Considerations
  Income Tax Rules
    Corporate Tax Rates
    – Basic Rate Structure
    – No "Adjusted Gross Income"
    – No preferential capital gains rate
  Flow – through entity taxation
    – Sole Proprietor
    – Partnerships
    – S Corporations
  Income tax rules with respect to the charitable deduction covered below

Estate Planning Fundamentals

Business Succession Planning With A Charitable Twist

I. Introduction to Business Succession Planning (cont)

A. Tax Considerations (cont)

Transfer Tax Rules
- Estate And Gift Tax Planning Is Driven By 2 General Rules, And 5 Exceptions To Those Rules

- General Rule #1: Gratuitous Transfers Are Taxable
  – Gifts During Life
  – Transfers At Death
- Four Exceptions To Rule #1:
  – Marital Deduction
  – Annual Gifts (And Qualifying Transfers)
  – Charitable Gifts
  – Applicable Exemption Amount

Estate Planning Fundamentals

Business Succession Planning With A Charitable Twist

I. Introduction to Business Succession Planning (cont)
Transfer Tax Rules (cont)
<u>Exception #1: Marital Deduction</u>
  – Transfers From One Spouse To The Other Are Not Subject To Estate Or Gift Tax

  – Transfers May Be During Life Or At Death
  – During Life - To Equalize Estates
  – During Life - Asset Protection Planning
  – At Death - Financial Support For Survivor

  – Transfers May Be Outright Or In Trust

  – Surviving Spouse Must Be A U.S. Citizen

Estate Planning Fundamentals

Business Succession Planning With A Charitable Twist

I. Introduction to Business Succession Planning (cont)

Transfer Tax Rules (cont)

Exception #2: Annual Gifts

- Anyone May Give Up To $14,000 Each Year To Any Number of Donees
- Gifts May Be:
  - Outright Or Through Qualifying Trusts
  - Cash Or Other Property
- Gift Must Be Of A "Present Interest"
- May Also Make Qualifying Transfers - Direct Payment Of Another's Medical Or Educational Expenses

Over Time - THE MOST POWERFUL ESTATE PLANNING TOOL

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I. Introduction to Business Succession Planning (cont)

Transfer Tax Rules (cont)

Exception #3: Charitable Gifts

- Properly Structured Charitable Gifts May Give Rise To:
  - Income Tax Charitable Deduction
  - Estate Tax Charitable Deduction
  - Gift Tax Charitable Deduction
- "Split Interest" Charitable Gifts May Give Rise To:
  - Income, Estate and Gift Tax Charitable Deductions
  - Ability To Diversify Assets Without Current Capital Gains Tax
  - Potential To Enhance Current And Continuing Yield On Investments
  - Benefits To Charity(ies) Of Your Choice

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I. Introduction to Business Succession Planning (cont)

Transfer Tax Rules (cont)

Exception #3: Charitable Gifts (Cont)

- Income Tax Deductibility Of Charitable Gifts Is Subject To Limitations Based On:
  - Type Of Charity
    - Public
    - Private
  - Type Of Property Donated
    - Cash
    - Ordinary Income Property
    - Long Term Capital Gain Property
    - Property Unrelated To Charity's Use
- Donor's Adjusted Gross Income
- Donor's Itemized Deductions

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I. Introduction to Business Succession Planning (cont)

Transfer Tax Rules (cont)

Exception #3: Charitable Gifts (Cont)

	Public (50%)	Private (30%)
– Cash	50% AGI	30% AGI
– Ordinary Income Property	50% AGI*	20% AGI*
– LT Capital Gain Property	30% AGI	20% AGI**
– Property Unrelated To Use	50% AGI*	20% AGI*

*Lower of cost or fair market value

** Limited to cost basis unless publicly traded securities

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I. Introduction to Business Succession Planning (cont)

Transfer Tax Rules (cont)

Exception #4: Applicable Exemption Amount

- In Addition To:
  - Marital Deduction
  - Annual Gifts
  - Charitable Gifts
- Everyone Can Transfer $5,000,000 Free Of Gift or Estate Tax
- Indexed, so actually $ 5,450,000 in 2016
- Can Use During Life Or At Death

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Estate Planning Fundamentals

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I. Introduction to Business Succession Planning (cont)

Transfer Tax Rules (cont)

General Rule #2: Generation Skipping Transfers Are Subject To An ADDITIONAL 40% Tax

- One Exception: Everyone Has A $5 Million Exemption From The Generation Skipping Transfer Tax ("GSTT"), also indexed so $5,450,000 in 2016
- One "Exclusion": Properly Structured $14,000 Annual Gifts Do Not Count Against The $ 5 Million Exemption

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I. Introduction to Business Succession Planning (cont)

With That Background, Estate Planning (And Business Succession Planning) Breaks Down Into Three Phases:

- Phase I "Basic" Planning
  - Wills/RLTs With Credit Shelter, QTIP Marital And GST Exempt Trusts
  - Appropriate Powers Of Attorney For Disability And Health Care Decisions
  - Verify All Beneficiary Designations For Contractual Assets
- Phase II Liquidity/Dilution Planning
- Phase III "Estate Reduction"

Reducing The Taxable Value Of The Estate Without Losing Control

Estate Planning Fundamentals

Business Succession Planning With A Charitable Twist

I. Introduction to Business Succession Planning (cont)

B. Non-Tax Aspects

Family Dynamics
- Control
- Equalization of Wealth

Successor Management

Business Succession Planning With A Charitable Twist

II. Seven Techniques For Highly Successful Business Owners

- These Seven Techniques Are Not Exhaustive
- These Seven Techniques Are Not Exclusive
- Overriding Planning Consideration Is - What Does The Owner Want To Do?

Business Succession Planning

Business Succession Planning With A Charitable Twist

II. Seven Techniques For Highly Successful Business Owners (cont)

- Seven Techniques Are:
  - Buy/Sell Agreements
  - "Bootstrap" Acquisition
  - Family Limited Partnerships/Limited Liability Companies
  - Grantor Retained Annuity Trusts
  - "S" Corp. Recapitalization
  - Sales to Intentionally Defective Grantor Trusts
  - Charitable Remainder Trusts
- Remember - Not Exclusive - Not Exhaustive

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II. Seven Techniques For Highly Successful Business Owners (cont)

A. Technique #1: Buy/Sell Agreements

What It Is

- Agreement Among Company And Shareholders To Buy Stock From The Shareholders Upon Certain Events - 5 "D's"
  - Disability
  - Divorce
  - Default
  - Departure
  - Death
- Most Common Technique Used For Succession Planning

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II. Seven Techniques For Highly Successful Business Owners (cont)

A. Technique #1: Buy/Sell Agreements (cont)

- Two Types Of Agreements
  - Stock Redemption - Company Buys Stock From Shareholder
  - Cross Purchase - Other Shareholder(s) Buy Stock From Shareholder
  - May Have Both Within The Same Agreement
  - Common To Use Insurance To Provide Funding
- How It Works
- Company And Shareholders Enter Into Agreement
- Upon Specified Event, Affected Shareholder Must Sell Stock To Company And/or Other Shareholders

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II. Seven Techniques For Highly Successful Business Owners (cont)

A. Technique #1: Buy/Sell Agreements (cont)

- Price Is Either Set Annually, Or More Likely, An Appraisal Process Is Outlined In The Agreement
- Purchase Is Usually Over Some Period Of Time
- Advantages Of This Technique
  - Provides Protection To The Company and Shareholders
  - Provides Liquidity To Shareholders
- Disadvantage Is That Accomplishes Only Minimal Estate Planning

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II. Seven Techniques For Highly Successful Business Owners (cont)

B. Technique #2: "Bootstrap" Acquisitions

What It Is

- Combined Stock Redemption And Outright Sale (Or Gift) To Allow Key Employee(s) (Or Next Generation) To Acquire The Business Without Having To Pay Full Value
- Seller Still Receives Full Value

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II. Seven Techniques For Highly Successful Business Owners (cont)

B. Technique #2: "Bootstrap" Acquisitions (cont)

How It Works

- Selling Shareholder Sells (Or Gives) A Small Percentage To The Acquiring Shareholder
- Selling Shareholder Sells The Balance Of Shares To The Company
- Selling Shareholder Receives Full Value
- Acquiring Shareholder (Who Now Owns All Outstanding Shares) Has Paid For Only A Small Percentage Of Company
- Company, In Effect, Finances Purchase Of Itself

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II. Seven Techniques For Highly Successful Business Owners (cont)

C. Technique #3: Family Limited Partnerships/Limited Liability Companies

What It Is

- Family Limited Partnership ("FLP") Is A Limited Partnership Formed Under State Law
- There Are 2 Classes Of Partners:
  - General Partner - Very Little Economic Interest (Typically 1%) But Virtually All Management Control
  - Limited Partner - Virtually All Of The Economic Interest, But Very Little Management Control
- Donor Generation Transfers Certain Assets To The FLP In Exchange For Both The General Partner And Limited Partner Interests
- Structured Properly, This Is An Income Tax Free Exchange

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II. Seven Techniques For Highly Successful Business Owners (cont)

C. Technique #3: Family Limited Partnerships (cont)

How It Works

- After Formation And Funding, Donor Generation Makes Gifts Of Limited Partner Interest To The Next Generation, Using The Annual Gift Exclusion And The Applicable Exemption Amount
- The Principal Gift And Estate Tax Benefit - The Ability To Discount The Value Of The Limited Partner Interests.
- There Are Two Types Of Discounts:
  - Lack Of Marketability
  - Minority Interest (Lack Of Management Control)
- A FLP Also Allows The Donor Generation (Usually The Parents) To Retain Control – Within Reason - Of The Assets Of The Partnership By Retaining The General Partner Interest

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II. Seven Techniques For Highly Successful Business Owners (cont)

C. Technique #3: Family Limited Partnerships (cont)

- Other Benefits Include:
  - Partnerships Are More Flexible Than Corporations;
  - Avoid Possible Double Taxation;
  - Consolidation Of Assets Can Simplify Management And Achieve Operational Cost Savings;
  - Equalization Of Wealth Within The Next Generation Even Where Less Than All Of The Next Generation Will Be Actively Involved In The Business;
  - Out-Of-State Assets Held By A FLP Avoid Ancillary Probate;
  - Avoid Fractionalizing Underlying Assets
  - Asset Protection Planning Opportunities

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II. Seven Techniques For Highly Successful Business Owners (cont)

D. Technique #4: "S" Corp. Recapitalization

What It Is

•FLP Type Technique For "S" Corporations
•How It Works
•"S" Corporation
  – Cannot Be Owned By A Partnership (FLP Not Available)
  – Cannot Have More Than One Class Of Stock
•However, The "S" Corporation Can Have More Than One Kind Of Stock, So Long As It Is Of The Same Class

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II. Seven Techniques For Highly Successful Business Owners (cont)

D. Technique #4: "S" Corp. Recapitalization (cont)

- "S" Corporation Is Recapitalized To Have:
  - Voting Common Stock
  - Non-Voting Common Stock

- Gifts Of Non-Voting Common Stock Are Then Made To The Next Generation
  - Discounting Available Because Of Lack Of Voting
  - Discounting Available Because Of Lack Of Marketability

- Often The Gifts Are Made Through A Grantor Retained Annuity Trust To Further Discount The Values

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II. Seven Techniques For Highly Successful Business Owners (cont)

E. Technique #5: Grantor Retained Annuity Trust

What It Is

- Grantor establishes irrevocable trust, retaining annuity payment, with remainder passing outright or in trust to next generation
- The present value of the remainder interest is a taxable gift, so often, the value is "zero'd out" by increasing the length or the percentage of the annuity payment
- The trust is funded with stock in the company, FLP/LLC interests, or non-voting common stock of a S corporation
- The goal is for the trust assets to earn or appreciate in value in an amount in excess of the IRS Applicable Federal Rate ("hurdle rate") for the month in which the GRAT is established

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II. Seven Techniques For Highly Successful Business Owners (cont)

E. Technique #5: Grantor Retained Annuity Trust (cont)

- Benefits Of A GRAT Include:
  - Leveraged gifting technique, transferring value in excess of hurdle rate at no transfer tax cost;
  - Gifting Leverage is increased when combined with FLP/LLC or non-voting common stock valuation discounts;

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II. Seven Techniques For Highly Successful Business Owners (cont)

F. Technique #6: Intentionally Defective Grantor Trusts

What It Is

- "Freezing" Technique
  - "Freeze" The Value Of An Asset
  - "Freeze" The Return On An Asset
- By Selling It For A Small Cash Down-Payment And A Long-Term, Interest-Bearing Note

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II. Seven Techniques For Highly Successful Business Owners (cont)

F. Technique #6: Intentionally Defective Grantor Trust (cont)

How It Works

- Donor Generation Establishes An Intentionally Defective Grantor Trust
  - A Defective Grantor Trust Is A Trust Where The Gift Is Complete To The Beneficiary For Estate And Gift Tax Purposes But The Trust Has A "Defect" Causing Income Tax To Be Charged To The Grantor Instead Of The Trust;
  - Allows Income Tax Free Growth Of The Assets In The Trust;
  - Payment Of The Income Tax Further Reduces The Grantor's Estate And Is Not Considered A Gift Subject To Gift Tax

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II. Seven Techniques For Highly Successful Business Owners (cont)

F. Technique #6: Intentionally Defective Grantor Trust (cont)

- Donor Generation Then Sells An Asset (Perhaps The Family Business) To The IDGT For A Small Cash Payment and A Long-Term Note
  - No Capital Gain On The Sale
  - Cash For Down Payment Came From Initial Funding Of Trust
  - Cash For Payments On The Note Come From The Asset That Was Purchased
- Donor Generation Now Has An Asset With A Fixed (Or "Frozen") Value, Which Pays A Fixed (Or "Frozen") Return
- Next Generation Now Has Future Appreciation From The Asset

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II. Seven Techniques For Highly Successful Business Owners (cont)

F. Technique #6: Intentionally Defective Grantor Trust (cont)

- IDGTs Are Sometimes Coupled With A FLP/LLC Which Allows Discounting Of The Asset Being Sold (Limited Partner Interests) AND Discounting Of The Asset Retained
- Sometimes The IDGT Is Established In A Jurisdiction Which Allows Perpetual Trusts, With The Result That The Assets Sold To The Trust Are Forever Removed From The Transfer Tax System

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II. Seven Techniques For Highly Successful Business Owners (cont)

G. Technique #7: Charitable Remainder Trusts

…which we will discuss after the break….

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II. Seven Techniques For Highly Successful Business Owners (cont)

Summary

- A Number Of Techniques To Carry Out Business Owner's Wishes At A Substantially Reduced Tax Cost
- Which Technique or Techniques Are Appropriate Depend Upon A Number of Factors, Primarily Whether Business Will Be Sold Or Passed On To Next Generation
- Whichever Technique(s) Is Used, Should Be Part Of A Comprehensive, Long-Range Business, Financial And Estate Plan

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Business Succession Planning

Business Succession Planning With A Charitable Twist

III. …With a Charitable Twist

A. A Deeper Look at CRTs

B. Charitable Lead Trusts

C. Indirect Giving Vehicles

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Business Succession Planning

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III. …With a Charitable Twist (cont)

A. A Deeper Look at CRTs

What It Is

- A Charitable Remainder Trust ("CRT") Is A Trust That:
  - Provides An Income Stream To Individual Beneficiaries For Their Lifetimes Or For A Term Of Years (Not To Exceed 20 Years);
  - At The End Of The Income Term, The Trust Assets Go To A Public Charity Or A Private Foundation;
  - The Grantor Receives An Immediate Income Tax Charitable Deduction For The Present Value Of The Remainder Interest Going To The Charity;
  - Allows The Conversion Of Appreciated Assets To Other Investments Without Incurring Current Capital Gains Taxation

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III. …With a Charitable Twist (cont)

A. A Deeper Look at CRTs (cont)

There Are Two Basic Types Of CRTs:

- Charitable Remainder Annuity Trust ("CRAT")
  - Pays A Specified Percentage (5% - 50%) Of Its Initial Fair Market Value To The Income Beneficiary Each Year;
  - Annual Payment Does Not Change, Making The CRAT Attractive To Someone Who Needs A Steady Income Stream;
  - Additional Contributions Cannot Be Made To A CRAT
- Charitable Remainder Unitrust ("CRUT")
  - Pays A Specific Percentage (5% - 50%) Of Its Annually Determined Fair Market Value To The Income Beneficiary;
  - Annual Payments Increase Or Decrease With The Value Of The Assets Held By The Trust;

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III. …With a Charitable Twist (cont)

A. A Deeper Look at CRTs (cont)

- A CRUT Is Appropriate For An Income Beneficiary Who Wishes To Benefit From The Appreciation Of The Trust Assets, But Who Will Not Have A Problem If The Annual Payments Decrease Due To A Reduction In The Value Of The Trust Assets;
- Additional Contributions May Be Made To A CRUT

– CRUTs Can Also Be Structured To Limit The Annual Payout To The Lesser Of Actual Net Income Of The Trust Or The Specified Payout Percentage ("NIMCRUT")

– CRUTs Can Also Be Structured As A "Flip Unitrust" Which Allows Switching From A NIMCRUT To A Regular CRUT When An Illiquid Asset Is Used To Fund The CRUT And Is Later Sold

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III. …With a Charitable Twist (cont)

A. A Deeper Look at CRTs (cont)

How It Works

- Highly Appreciated Assets, Such As Stock Or Business Interest, Are Contributed To The CRT
- The Donor Receives A Charitable Income Tax Deduction Based On The Fair Market Value Of The Assets transferred To The Trust
  - Generally, Only The Cost Basis Of The Assets Will Be Used If A Private Foundation Is The Remainder Beneficiary
- The Charitable Deduction Equals The Actuarial Present Value Of The Remainder Interest, Which Is Based On the Length Of The Trust Term, The Discount Rate Used, And The Annual Payout Percentage

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III. …With a Charitable Twist (cont)

A. A Deeper Look at CRTs (cont)

- Deductions Are Also Limited By The Type Of Property Contributed, And By Whether The Charity Is A Public Charity Or A Private Charity
- Unused Or Limited Charitable Deductions Can Be Carried Forward Five Tax Years, Subject To The Same AGI Limitations
- The CRT Is Tax-Exempt, So It Can Sell The Appreciated Assets And Diversify Its Investment Portfolio Without Incurring Capital Gains Tax

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III. …With a Charitable Twist (cont)

A. A Deeper Look at CRTs (cont)

- If The Income Beneficiary Is Someone Other Than The Grantor And/or The Grantor's Spouse, A Taxable Gift Has Occurred, The Value Of Which Is The Present Value Of The Income Stream
- If There Is A Concern That The Estate Passing To The Family Is Being Reduced By The Charitable Gift, This May Be Solved By Purchasing Life Insurance, Which Should Be Owned By A Life Insurance Trust

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III. …With a Charitable Twist (cont)

B. Charitable Lead Trusts

- Irrevocable trust
- Inter vivos or testamentary
- Charitable beneficiary receives the "income" interest, either an annuity or unitrust amount
- "Income" interest is payable for life, lives, or term of years (notice, no limitation on term of years), or even for a life plus term of years
- Non-charitable beneficiary receives the remainder interest

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III. …With a Charitable Twist (cont)

B. Charitable Lead Trusts (cont)

- "Income" interest must be either:
  - Guaranteed Annuity Interest, which is a sum certain at least annually (CLAT)
  - Unitrust Interest, which is a fixed percentage of trust assets, revalued annually (CLUT)

- CLT must also be either
  - Grantor Trust – donor entitled to income tax charitable deduction when funded, but must also report income of trust in future years
  - Non-grantor Trust – no up-front income tax deduction, but the trust itself is responsible for any income tax consequences

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III. …With a Charitable Twist (cont)

B. Charitable Lead Trusts (cont)

- Types of CLTs
  - Charitable Lead Annuity Trust (CLAT)
  - Charitable Lead Unitrust (CLUT)

- Benefits of CLTs/Planning Thoughts
  - Non-grantor CLT is a leveraged gifting technique, similar in structure and purpose to a Grantor Retained Annuity Trust (GRAT)
  - Non-grantor CLT has incidental income tax benefit of not being subject to AGI limits or itemized deduction phase-outs

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III. …With a Charitable Twist (cont)

B. Charitable Lead Trusts (cont)

- Benefits of CLTs/Planning Thoughts (cont)
  - All CLTs allow funding charitable gifts without permanently giving away an asset
  - Grantor CLT provides current income tax charitable deduction for present value of the income stream going to charity in future years, which may be useful against income spike
  - CLTs are not tax exempt, so either grantor (of grantor CLT) or the trust itself are subject to income tax
  - CLTs are subject to private foundation rules

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III. …With a Charitable Twist (cont)

B. Charitable Lead Trusts (cont)

- Benefits of CLTs/Planning Thoughts (cont.)
  - Avoid contributing encumbered property, because of possible gain recognition and UBTI issues
  - Monitor funding with closely-held stock or FLP interests because of excess business holding rules

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III. …With a Charitable Twist (cont)

C. Indirect Giving Vehicles

- Private Foundations
  - 6 Excise Taxes
    - Net Investment Income
    - Self-dealing
    - Failure to Distribute
    - Excess Business Holdings
    - Jeopardy Investments
    - Taxable Expenditures
- Donor Advised Funds

Business Succession Planning

Business Succession Planning With A Charitable Twist

IV. Case Studies

A. A Traditional Pre-Sale Strategy
  - [client was a principal owner of a 6th generation family owned business, whereby he used 2 large direct gifts to charity, 3 CRTs, 1 CLT and 2 private foundations to accomplish his varied goals]

B. A Charitable Bail-Out
  - [use of a "Bootstrap Acquisition" in combination with charitable gifts of stock, subsequently redeemed by the corporation, to increase speed of transfer of company to next generation, relieve accumulated earnings issues inside the company, and accomplish significant charitable giving]

Business Succession Planning

Business Succession Planning With A Charitable Twist

IV. Case Studies (cont)

A. Traditional Pre-Sale Strategy
- Client was 4th generation of family-owned business
- 92 family member shareholders, 4th, 5th and 6th generations
- Client owned approximately $26 Million of stock, essentially zero basis, and had already transferred approximately $15 Million of stock to the next generation
- Charitably inclined, particularly to higher education, animal welfare, local food bank
- Pre-sale, 2 $500,000 gifts of stock to 2 colleges, funded two CRTs with $1 MM each, to each of those colleges.
- Pre-sale, members of the family established foundation to replace corporate philanthropy that they feared would be lost.

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IV. Case Studies (cont)

A. Traditional Pre-Sale Strategy
- Pre-sale, 3rd CRT to the family foundation
- Post-sale, realized other family members were not supporting the foundation, so set up a CLT (with generation skipping provisions)
- Post-sale, set up his own private foundation to carry out his favored causes
- 2 large direct gifts, 3 CRTs, 1 CLT, and 2 foundations would seem to be overkill, but not in this situation

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IV. Case Studies (cont)

B. A Charitable Bail-Out
- Generation 1 starts business
- At death of Generation 1, business owned 45% by GST trusts, 45% by non-GST Trust, and 10% by Generation 2 (via lifetime gifting)
- With no planning, 55% of ownership will be subject to estate tax at death of Generation 2
- Business is C corporation, extremely profitable, causing some concern with accumulated earnings tax exposure
- Value of business has grown so that limited ability to transfer during lives of Generation 2 even with maximum non-taxable gifts
- Generation 2 is extremely charitable

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Business Succession Planning

Business Succession Planning With A Charitable Twist

IV. Case Studies (cont)

B. A Charitable Bail-Out

- 2 (out of 4) children of Generation 3 are involved in business
- Generation 2 makes annual gifts, and $1 Million ($2 Million with spouse) stock gifts to Generation 3 (but that only goes so far)
- Generation 2 makes large stock gifts to favorite charity (large, non-cash gift, to public charity, so FMV deduction)
- Company purchases and retires stock from charity, reduces percentage of outstanding stock owned by Generation 2, and increases percentages of outstanding stock owned by the GST Trusts and Generation 3
- This is permissible so long as there is no pre-existing obligation on part of company to buy, or on part of charity to sell

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