The Estate Planner's Guide to the "Deal" – What Do I Need to Know When My Client Is Selling His/Her Business?

June 2017

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The business attorney's focus when advising a client selling a business is necessarily the transaction itself. Primary considerations typically include maximizing the purchase price, reducing the income and other (e.g., real estate excise) taxes resulting from the transaction, and minimizing post-transfer contingencies placed upon the seller's receipt of the sale proceeds (e.g., earn-out provisions). Although all of these factors are important to the estate planning attorney, pre- and post-sale activities can be equally critical to best achieve the client's long-term tax-minimization, succession, and charitable goals. While these materials are by no means comprehensive, this presentation discusses select issues the estate planning attorney should consider when a client intends to sell a closely-held business.[1]

1. **Pre-Transaction Planning:** It is critical for a potential seller to be aware of major estate planning considerations well in advance of the decision to sell the business, particularly because it may be too late to implement certain techniques immediately before the sale. If addressed in a timely manner, pre-sale planning can leverage the owners' gift, estate, and generation-skipping transfer tax exemptions to shift significant wealth out of the taxable estate. As discussed below, however, the owner must be proactive in doing so well before the business sale itself.

a. Estate and Gift Taxes (Generally): Pursuant to the American Taxpayer Relief Act of 2012 (ATRA 2012), the gift and estate tax exemption amount for 2017 is $5.49 million per individual ($5 million exemption indexed for inflation), or $10.98 million per married couple. Pursuant to ATRA 2012, the current gift and estate tax rate on amounts in excess of the exemption is 40%. The exemptions enable individuals and married couples to make lifetime gifts or leave inheritances up to these limits without paying any federal gift or estate tax. At the federal level, any unused exemption of the first spouse may be allocated to the surviving spouse by making the appropriate election on the first spouse's federal estate tax return (IRS Form 706).[2]

Generally speaking, lifetime taxable gifts (i.e., those gifts that require filing a federal gift tax return, IRS Form 709) reduce the federal gift and estate tax exemptions on a dollar-for dollar basis (for example, a lifetime taxable gift of $1,000,000 reduces both the federal gift and estate tax exemptions to $4.49 million).[3] Any lifetime

[1] Due to time constraints, these materials do not address securities law considerations. For a discussion of those issues, see *The Intersection of Business Transactions and Estate Planning: What Every Estate Planner Needs to know about Business Law in the Context of Tax Planning*, Benetta P. Jenson and David Herzig, 61st Annual Washington State Estate Planning Seminar.

[2] IRC Section 2010(c) allows a surviving spouse to claim the deceased spouse's unused exclusion (DSUE) on a timely-filed federal estate tax return.

[3] In contrast, the Washington State per-individual exemption is $2.129 million, indexed to inflation, and there is no Washington State gift or generation-skipping transfer tax. As a result (and unlike the federal tax), Washington State estate tax can be completely avoided by making gifts during life to reduce the retained assets at death below the Washington State estate tax exemption. Although the planning techniques discussed herein are also very effective in reducing Washington State estate tax, these materials focus on the more complex federal tax issues.

gifts in excess of the $5.49 million individual/$10.98 million married couple exemption, or any amounts transferred on death in excess of the remaining exemption, will be subject to the applicable gift or estate tax at the rate in effect at the time of the transfer. However, annual lifetime gifts can be made tax-free to an unlimited number of recipients without reducing the donor's federal gift and estate tax exemptions so long as the gifts do not exceed the "annual exclusion" from the gift tax. The 2017 annual exclusion for gifts is $14,000 per donor/per beneficiary/per year, or $28,000 per married couple/per beneficiary/per year.

b. Valuation Discounts: The estate tax value of a closely-held (private) entity wholly owned by the decedent at death is likely to equal or approximate the value of the entity's underlying assets. However, where minority interests in such entities are transferred (or owned at death), the value of the interests will likely be eligible for substantial minority interest and lack of marketability discounts, or discounts due to other restrictions on the recipient's ability to subsequently transfer or benefit from the interests. These discounts enable donors to transfer assets out of their taxable estates at a fraction of the proportionate value of the underlying assets, preserving more exemption to allocate to the taxable estate at death.

i. **Example #1:** Assume the client's wholly-owned limited liability company (LLC) holds a commercial building with a fair-market value of $4.8 million, and a $200,000 cash account. If the client owns 100% of the entity at death, the estate tax value of the interest is likely equal to the $5 million underlying asset value. However, if the same client transfers 20% interests to each of her five (5) children, such minority-interest transfers may be eligible for substantial valuation discounts. If a hypothetical 40% discount is determined by a certified appraiser, the client effectively moves a $5 million LLC out of her estate at an exemption "cost" of $3 million, preserving an extra $2,000,000 of federal exemption to shield her assets from the 40% estate tax at death.

ii. Proposed Treasury Regulation § 25.2704-3: Proposed Treasury Regulation § 25.2704-3, issued August 2, 2016, intends to eliminate almost all minority (lack of control) discounts (but not lack of marketability discounts) for closely-held entity interests, including active businesses owned by a family. As of January 20, 2017, the Trump administration has issued a regulatory freeze, requiring that any new regulations be reviewed and approved by a department or agency head appointed by President Trump. This essentially prohibits any federal funds from being used to finalize and implement the 2704 proposed regulations. As a result, it is presently unclear whether the proposed regulations will be finalized within the next four years.

Planning Tip: When reporting discounted gifts on a federal gift tax return (IRS Form 709), consider whether, for gift tax statute of limitation purposes, you should disclose that minority interest valuation discounts are contrary to Proposed Treasury Regulation, § 25.2704-3.

c. Timing is Critical: Due to the current freeze on the proposed §25.2704-3 regulations, business owners remain able to transfer minority business interests out of their estate (by gift or sale) at minority-discounted values. However, business owners should be advised that procrastination may limit discounts, or render them entirely unavailable. Case law indicates that the courts view a third-party sale of a minority business interest transaction (for the purposes of these materials, an "outside sale") within a reasonable time of a valuation date to be the most compelling evidence of the earlier gift tax value of a similar minority interest.

> "Actual sales made in reasonable amounts at arm's length, in the normal course of business within a reasonable time before or after the valuation date are the best criteria of market value." *Fitts' Estate v. Commissioner*, 237 F.2d 729 (8th Cir. 1956); *Duncan Industries, Inc. v. Commissioner*, 73 T.C. 266, 276 (1979).

For example, in *Estate of Helen M. Noble*, et. al., T.C. Memo 2005-2, the court upheld the IRS's estate tax valuation of the decedent's minority stock interest based on an outside sale of a similar minority interest occurring a little over a year after death. The court found that the post-death sale was sufficiently contemporaneous and the most relevant evidence for evaluating the stock's price at the date of death. In *Nathan P. Morton, et. ux,* T.C. Memo 1997-166, a confidential private placement memorandum dated 15 months after a transfer date was held relevant to the valuation of the stock at the date of death. However, a prospectus for a public offering prepared two and a half (2 ½) years after the date of death was deemed insufficiently foreseeable as to be relevant. In *Estate of Jung*, T.C. Memo 1990-5, the Tax Court ruled that stock sales occurring twenty-seven (27) months after the decedent's death were relevant to the stock's date of death value for estate tax purposes.

Clients who wish to transfer business interests for the benefit of children or other beneficiaries are therefore prudent to do so well in advance of an outside sale. If the intra-family transfer and the outside sale are too close in time, the IRS may assert that the outside sale value applies to the (often heavily discounted) prior intra-family transfer.[4] Such a revaluation would have the effect of either (i) utilizing a greater portion of the owners' federal estate and gift tax exemptions, likely resulting in increased estate taxes at death; or (2) producing a greater than expected gift tax liability. The transfer methods discussed below thus all assume that the business-owner client carries out the prior intra-family transfers well in advance of the outside sale.

[4] This discussion assumes the business interests appreciate over time, i.e., the prior intra-family (discounted) transfer value is lower than the post-intra-family outside sale value. If the situation is reversed, these timing risks may in fact provide the client the option to amend gift tax returns to reflect less exemption use.

Planning Tip: To reduce the risk of a subsequent transfer tax revaluation, it is helpful if the gratuitous transfer is made at least 15 months before the outside sale. The best practice is to try to plan for a *minimum* of two (2) years between the gratuitous transfer and the outside sale.

d. Estate Freeze Transfers. For individuals with significant wealth, the $14,000 annual exclusion plus the gift and estate tax exemptions may be insufficient to avoid estate tax. In such case, additional estate planning is typically justified. An "estate freeze" generally refers to any transaction that fixes the current value of an asset for the transferor, while moving the value of future appreciation of that asset to the transferee. Due to the availability of the valuation discounts discussed above, estate freeze techniques can be particularly powerful when applied to closely-held business interests well in advance of an outside sale.

Estate freeze transactions may take the form of gifts or sales, or a mixture of both. Generally speaking, making gifts is typically the simplest estate freeze method for transferring business interests to beneficiaries. Gifts are generally appropriate when business owner clients (i) have beneficiaries they wish to benefit, and (ii) are confident they have sufficient other assets to support their accustomed manner of living beyond their expected life spans. In the absence of an outside sale event fixing the price of the transferred interests, significant wealth can be transferred out of the owners' estates at a fraction of the (or no) transfer tax cost.

Some effective estate freeze strategies for the business owner include (i) family entity transfers to generation-skipping trusts; (ii) intentionally defective grantor trusts; (iii) grantor-retained annuity trusts; and (iv) charitable remainder unitrusts. Discussing any of these estate planning techniques in detail is beyond the scope of this article, and these materials assume a general level of familiarity with each planning option discussed below.

i. Gifts, Generally: Making gifts of stock or other minority entity ownership interests is a very effective estate tax reduction strategy. By gifting entity interests (as compared to cash), any future appreciation above the value of the interests on the date of the gift is transferred out of the estate. No income taxes are due when the gift is made, though the owner's cost basis in the gifted assets transfers over to the gift recipient. Finally, the value of the gifted interests may be eligible for substantial valuation discounts, as discussed above.

ii. Family Entity Transfers to Generation Skipping Transfer Trusts (GST Trusts): Making gifts of closely-held business interests to a Generation Skipping Transfer (GST) tax exempt trust can shield business assets from transfer taxes for several generations. This is primarily due to the combination of (1) the historically high estate and GST tax exemptions, (2) valuation discounts, and (3) the lack of a Washington State GST tax.

A GST Trust is one method to take advantage of an owner's (currently) $5.49 million GST tax (GSTT) exemption. The GSTT generally restricts persons from making substantial tax-free gifts that skip their children and pass directly to their grandchildren and later descendants. Assets in excess of a decedent's GSTT exemption that skip to the grandchildren's level (directly or in trust) are thus subjected to two taxes – the regular estate tax and the GSTT – as if the assets had passed through the children's estates on their way to the grandchildren. As a result, the total combined tax can reach (or exceed) 80% for non-exempt generation-skipping transfers.

Allocating GSTT exemption to a transfer to trust exempts such trust assets from estate and GST tax at multiple deaths for the duration of the trust.[5] Without the application of transfer tax over multiple generations, appreciation can dwarf the initially-transferred (discounted) value, making gifting an owner's business interest prior to an expected significant increase in value very effective for future estate tax reduction: all future appreciation is transferred to the beneficiaries without being subject to transfer taxes in multiple owners' estates.

A. **Example #2**: Again assume the client's wholly-owned limited liability company (LLC) holds an operating business with a 100% controlled fair market value of $5 million. Assume further that in year one the client transfers 20% interests to GST trusts for each of her five (5) children, and a 40% discount is applied to each transfer by a certified appraiser (using $3 million of her $5.49 million federal GSTT, estate, and gift tax exemptions). Finally, assume in year five that the children's trusts collectively sell 100% of the business to a third party for $7 million. In such case, the client has moved a $7 million asset out of her estate at an exemption "cost" of $3 million, shielding $4 million of assets from the 40% estate tax at death. Additionally, because the trust is GSTT-exempt, it can appreciate to an unlimited extent and escape estate and GST tax at each successive generation for the duration of the trust.

B. IRC § 2036(a) Audit Risk: Discounted transfers of family-entity interests are commonly challenged by the Service as ineffective to avoid the transferor's future estate tax. The Service typically argues that, pursuant to Internal Revenue Code ("IRC" or the "Code") § 2036(a), these lifetime transfers should be disregarded and brought back into the estate to be estate taxed at the date of death (or alternate valuation date) value. The recent Tax Court memorandum opinion in *Estate of Purdue*, T.C. Memo. 2015-249,[6] provides a road map for protecting against such aggressive § 2036(a) audits. Generally speaking, pre- and post-transfer facts and activities are critical to the estate's defense. In ruling for the *Purdue* estate, the Tax Court determined that the value of the assets transferred by Mrs. Purdue seven years prior to her death to a family limited liability company, minority interests of which were

[5] RCW 11.98.130 generally limits Washington State trusts to 150 years.

[6] Montgomery Purdue Blankinship & Austin PLLC represented the estate in *Estate of Purdue*. See http://www.mpba.com/blog/tax-court-rules-for-mpba-clients-in-rejecting-aggressive-irs-estate-tax-claim/ for additional detail.

later gifted at discounted values for the benefit of her family members, was not included in her gross estate under IRC §2036(a) because the bona fide sale for adequate and full consideration exception to § 2036(a) applied. The Court's ruling was dependent, in part, on the following factors.

1. The record established legitimate and significant nontax reasons for creating the family limited liability company (the "FLLC");

2. The Purdues were not financially dependent on FLLC distributions;

3. The Purdues did not commingle personal funds with FLLC funds;

4. The FLLC maintained clear records and entity formalities were respected;

5. The assets were timely transferred to the FLLC; and

6. The Purdues were not in poor health at the time of the transfers to the FLLC.

Planning Tip: For estate planners assisting clients with a family limited liability or limited partnership transfer strategy, *Estate of Purdue* provides useful guidance on beneficial pre- and post-transfer client activities. In general, advise your clients to be meticulous in (1) documenting and implementing the non-tax reasons for the family business gifting plan, and (2) treating the family business in the same manner as any other business entity, *e.g.*, the owners should conduct regular meetings, adopt and update business and investment plans; and regularly document meetings and decisions with minutes and resolutions.

iii. Sale to an Intentionally Defective Grantor Trust: Although gifting is often the most advantageous estate tax minimization strategy, in many cases, the business owner requires a retained income stream from the transferred business interests. If so, a sale to an intentionally-defective grantor trust (IDGT) is an attractive option. A sale of stock for fair-market value does not use any of the business owners' tax exemptions. Moreover, because the IDGT is structured as a "grantor trust"[7] (*i.e.*, it is treated as one and the same as the grantor for income tax purposes), purchase payments from the IDGT to the owner generally are not subject to income tax.[8] As a result, the sale of discounted minority interests to the IDGT can accomplish the same estate freeze technique as the family entity GST Trust gifts described above (and

[7] IRC Secs. 671-678 provide the circumstances in which trust income will be taxed as if owned by the grantor or a beneficiary.
[8] See, e.g., PLR 9535026.

subsequent outside sale proceeds transfer to the beneficiaries), but also provide an income-tax free sale proceeds stream back to the grantor.

A primary audit concern with IDGT sales is that the IRS may argue that the transferred assets are subject to Code §§ 2036(a), 2701 and 2702, in which case the sale is generally disregarded, and under the worst-case scenario, results in the inclusion of the full date of death (i.e., appreciated) value of all of the trust assets in the estate. Although the IRS ruled that these Code sections did not apply to an IDGT sale in PLR 9535026, the rulings were conditioned on the assumption that the note retained by the seller was *bona fide* debt. If it was a retained income or equity interest instead, the IRS warned that all three sections could apply.

Many commentators believe that the key to qualifying the promissory note as bona fide debt is to make sure that the trust's debt/equity ratio is not too high by funding the trust with an amount at least 10%[9] of the overall sale transaction (*e.g.*, if the sale is for $1,000,000, the trust should be funded with property worth at least $100,000). The amount the trust is funded with prior to the sale is generally referred to as "seed money." Unfortunately, there is very little specific guidance from the IRS or from the courts on when an IDGT note crosses the line into an equity interest. Thus, tax advisors have been left wondering how much seed money is truly required.

Another commonly overlooked risk with sales of closely-held business interests to an IDGT is that the IRS may, in a later estate tax return audit, allege that the sale price was insufficient (a "bargain sale"), resulting in an immediate constructive taxable gift from the seller to the IDGT trust beneficiaries in the year of the sale. That argument may be made, even with no realistic chance of prevailing, primarily to put extra pressure on the estate to settle its estate tax issues.[10]

[9] See, e.g., "Using Beneficiary Guarantees in Defective Grantor Trusts," Milford B. Hatcher, Jr., and Edward M. Manigault, 92 JTAX 152 (March 2000) .

[10] For example, incidental to the *Estate of Purdue* § 2036(a) issue, the IRS also asserted in the Tax Court litigation, 14 years after the fact, that the decedent made a year 2001 constructive bargain sale taxable gift to her children. The Service alleged that she did so by acquiescing to a non prorata distribution from her deceased husband's estate of an improperly valued minority LLC interest in satisfaction of their fractional beneficial estate share. Although the Service argument was frivolous (the valuation of that minority LLC interest was supported by an unchallenged independent appraisal), the estate net worth exceeded the $2,000,000 IRC § 2412 maximum necessary to be eligible for an award of its attorney fees incurred overcoming the meritless gift tax deficiency.

Planning Tip: In LTR 9515039, the IRS ruled that a purchaser's guarantee would suffice in the context of a private annuity sale, provided that the guarantor had sufficient personal assets to make good on the guarantee. Consider using beneficiary guarantees in conjunction with a minimum 10% seed gift to best support the bona fide aspect of the sale.

Planning Tip #2: The IRS can be prevented from alleging in a later estate tax return audit that a "bargain sale" occurred in the year of the sale to the IDGT by filing an IRS Form 709 (federal gift tax return) reporting no gift for the year of the sale.

iv. Grantor Retained Annuity Trusts**:** Most estate planners are familiar with the appreciation-shifting power of the Grantor Retained Annuity Trust ("GRAT") or Grantor Retained Unitrust ("GRUT"). Generally speaking, in each case, the grantor makes a gift of property to the trust and retains a payment right for a specified term. The payment right can be structured as an annuity (as is the case with a traditional GRAT) or a percentage of the assets (as is the case with a GRUT) (because the rules generally apply to both GRATs and GRUTs identically, these materials will refer only to GRATs below). At the end of the payment term, the trust terminates, and assets are distributed outright or held in trust for the remainder beneficiaries.

Under IRC § 2702(a)(2), the value of the gift to a GRAT is the fair-market value of the property transferred, minus the present value of the grantor's retained interest. In valuing the grantor's retained interest, federal tax law assumes that the trust assets will produce a return equal to the § 7520 rate in effect at the time of the transfer (2.4% in May 2017). If the GRAT assets produce a return greater than the § 7520 rate, the increase in value above that rate generally passes to the beneficiaries free of gift, estate, and generation-skipping transfer tax, so long as the grantor outlives the trust term. If the grantor dies during the trust term, the value of the remainder interest is included in the grantor's estate under Code § 2036(a). Accordingly, a GRAT is most effective when (a) the grantor is likely to outlive the trust term, and (b) the property transferred to the trust is highly likely to appreciate at a rate greater than the § 7520 rate.

It is possible to structure a GRAT so that the grantor's retained interest is approximately equal to the value of the property transferred to the trust, resulting in a remainder interest valued at zero or nearly zero. See *Walton v. Comm'r.*, 115 T.C. 589 (2000, *acq.* Notice 2003-72). As a result, the creation of this type of GRAT (called a "zeroed-out GRAT") results in minimal usage, if any, of the grantor's lifetime gift tax exemption. For business owner clients who have either used up all of their federal gift tax exemption, or do not wish to use a substantial portion (or any) of

their remaining exemption, a zeroed-out GRAT is a particularly useful pre-outside sale tool to transfer significant wealth to future generations.[11]

A. **Example #3**: Assume a married couple owns a closely-held business with a control valuation of $5 million for 100% of the stock. Further assume that the couple transfers minority interests in their family business to GRATs which are appraised at $3 million due to traditional valuation discounts. The transferors retain an aggregate 7% annuity stream which begins at $436,330 in year one, and increases by 20%[12] in each successive year of the term. Assume further that the business interests appreciate in value 7% annually, and in year four (4) of the GRAT term, the business is purchased by a third party in an outside sale for $7 million. In such case, the taxable gift the couple makes upon transfer is only $56.72 due to the assumption that assets will appreciate at the (May, 2017) 2.4% IRC § 7520 rate. However, the economic results of the GRAT are as follows:

Year	Opening Balance	Assumed Growth	Annuity	Closing Balance	Outside Sale
1	$3,000,000 (100 shares of stock)	$210,000	$436,330 (distributed in the form of 13.59 shares of stock)	$2,773,670 (86.41 shares of stock)	
2	$2,773,670 (86.41 shares of stock)	$194,157	$523,596 (distributed in the form of 15.24 shares of stock)	$2,444,231 (71.16 shares of stock)	
3	$2,444,231 (71.16 shares of stock)	$171,096	$628,315 (distributed in the form of 17.1 shares of stock)	$1,987,012 (54.06 shares of stock)	
4	$1,987,012 (54.06 shares of stock)	$139,091	$753,978 (distributed in the form of 19.7 shares of stock)	$1,372,124 (34.9 shares of stock)	34.9 shares sold for $2,443,000 (100% of the shares sold for $7 million)
5	$2,443,000 (cash)	$171,010	$904,774	$1,709,236	

[11] The Obama administration typically recommended disallowing zeroed-out GRATS in its annual budget proposals. To date, these proposals have not been widely supported.

[12] 20% is the maximum annual increase allowed for back loading the annuity payments to the end of the term. Reg. 25.2702-3(b)(1)(ii)(A). Generally, the longer the GRAT property can stay in the trust, the greater the chances for significant wealth transfer.

In the example illustrated above, the business owners shift $1,709,236 of value to their children for the exemption "cost" of $56.72. The significant (essentially tax-free) asset shift is the result of (1) the 7% actual growth rate far exceeding the assumed 2.4% IRC § 7520 rate, and (2) the additional appreciation resulting in the trust from the outside sale.

> **Planning Tip**: Similar to the "bargain sale" estate tax return audit risk for sales of minority family business interests to an IDGT, the IRS may similarly argue in a later estate tax return audit (many years after the fact), that in-kind payments from a GRAT in the form of entity interests (*e.g.*, the same minority family business interests originally contributed to the GRAT by the trustor) were improperly valued, resulting in a constructive bargain sale taxable gift in the year of the GRAT payment. A GRAT-related IRS bargain sale argument asserted for the first time in an estate tax return audit can also be prevented by filing an IRS Form 709 (federal gift tax return) reporting no gift for the year of the in-kind GRAT payment.

B. Beware of Uncertain Income Tax Consequences: Although the GRAT planning technique has been in use for decades, at least one significant uncertainty remains. During the GRAT term, the trust is a grantor trust with respect to the transferors. If the grantors die during the GRAT term, the GRAT will immediately cease to be a grantor trust. However, to ensure the lowest gift tax value upon the transfer of assets to the GRAT, typical GRATs will require that any remaining GRAT payments be made to the grantors' estates.[13] If the remaining payment must be made with stock or other entity interests (as opposed to cash), it is uncertain how such in-kind payment will be income taxed. One potential result is a complete avoidance of taxable income, which is the outcome some commentators believe to be correct.[14] Another possible result is that the GRATs will be income taxed on the difference between the fair market value and the cost basis of the stock at the time transferred back to the estates.[15] A third possible result is that the receipt of the GRAT payments by the grantor's estate will be income taxable to the estate under the installment sale rules of § 453 and § 691 as "income in respect of a decedent."[16]

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[13] Generally, if it is possible for the remainder interest to vest in the remainder beneficiaries prior to the expiration of the specified trust term (such as could be the case when the grantor fails to survive the term), the value of the interest retained by the grantor will be lower and the taxable gift will be higher. To avoid this, GRATs typically require that any remaining term payments be made to the grantor's estate.

[14] See Blattmachr, Gans and Jacobson, "*Income Tax Effects of Termination of Grantor Trust Status by Reason of the Grantor's Death*," Vol. 97, Number 03, Journal of Taxation (September 2002).

[15] See Rev. Rul. 83-75 (distribution by a trust of appreciated securities to satisfy its obligation to pay an eight percent (8%) annuity resulted in taxable gain to the trust); see also Reg. § 1.661(a)-2(f).

[16] Although GRAT payment obligations are not in a form evidenced by an interest-bearing promissory note, the grantor's transfer of appreciated property in exchange for the right to receive GRAT payments meets the § 453(b) definition of an "installment sale" ("a disposition of property where at least one payment is to be received after the close of the taxable year in which the disposition occurs"). GCM

The most likely result appears to be that the inclusion of the GRAT assets in the grantors' taxable estates due to their deaths results in a stepped-up income tax basis for those GRAT assets, as well as a stepped-up income tax basis in the estates' right to receive the GRAT payments. That should, in turn, result in no income tax liability either to the GRATs or to the grantor's estate when the GRAT payments are made.[17] However, the author is aware of no rulings or cases directly applicable to the income tax treatment of GRAT payments made to a decedent's estate that definitively confirm that result. It is therefore not possible for practitioners to assure clients that no income tax liability results if the grantors die prior to receiving all of the GRAT payments.

> **Planning Tip:** Be certain to identify the income tax uncertainty described above in advance of implementing a GRAT plan. Doing so will minimize the risk of a malpractice claim after the death of the grantor(s) if the IRS or the courts determine that the in-kind transfer is subject to income tax.

39503 (5/19/86) indicates that when payments from trusts do not end at the death of the grantor, or are otherwise to be completed within the actuarial life expectancy of the grantor, then they are taxable under § 453 rather than under the private annuity rules of § 72. The IRS position stated in GCM 39503 is that, where the grantor was required to report payments received from a trust during life under § 453, the payments after death are income taxable to the grantor's estate as IRD under § 691.

[17] Ronald Aucutt, in *Installment Sales to Grantor Trusts*, Business Entities (WG&L), Mar/Apr 2002, articulates the "no income tax" argument at page 16, as follows: "One of the most interesting inquiries regarding installment sales to grantor trusts relates to the income tax consequences if the grantor/seller/note-holder dies before the note is paid off. The IRS should be expected to argue that that causes a realization of the grantor's gain, to the extent the note is unpaid, similar to the realization that occurs when a grantor cures the defect or renounces the power that causes the trust to be a grantor trust. Estate planners have often assumed, without much analysis, that this would be the result perhaps by analogy to income in respect of a decedent (IRD)…[but] there should not be such realization at death. The gist of the argument is that for income tax purposes, under Rev. Rul. 85-13, there is no transfer of the underlying property to the trust while the trust is a grantor trust. Therefore, for income tax purposes, the transfer to the trust occurs at the grantor's death…. Thus, there is no gain realized on the property in the trust. Since the note is included in the decedent's gross estate, it receives a new basis - presumably a stepped-up basis-under Section 1014, unless it is an item of IRD under Section 691, which is excluded from the operation of Section 1014 by Section 1014(c). Since the fact, amount, and character of IRD are all determined in the same manner as if "the decedent had lived and received such amount," and since the decedent would not have realized any income in that case, there is no IRD associated with the note. Thus, the note receives a stepped-up basis and the subsequent payments on the note are not taxed. Confirmation of this treatment is seen in Sections 691(a)(4) and (5) which set forth rules specifically for installment obligations reportable by the decedent on the installment method under Section 453. In the case of installment sales to grantor trusts, of course, there was no sale at all for income tax purposes, and therefore there is nothing to report under Section 453. This is not an unreasonable result, since the income tax result is exactly the same as if the note had been paid before the grantor's death - no realization - which fulfills the policy behind Section 691. Moreover, if the unpaid portion of the note were subject to income tax on the grantor's death, the result would be double taxation, because the sold property, being excluded from the grantor's estate, does not receive a stepped-up basis."

Planning Tip: To minimize the risk of a grantor's death before a required GRAT payment is made, which increases the risk that the GRAT payment may be characterized as taxable IRD, consider recommending that the GRAT payment be made on its due date rather than later within the "105 day" period permitted by Section 25.2702-3(b)(4).

iv. Charitable Remainder Trusts. The charitable remainder unitrust ("CRUT")[18] option enables business owners to transfer business interests to a trust for their benefit, and name a charity of their choosing as the beneficiary of any amounts remaining in the trust at death (or at the end of the trust term if the term is not for the life of the grantor). The CRUT is very similar to the GRAT technique discussed above, except the remainder beneficiary is a charitable organization rather than the grantor's non-charitable beneficiaries. The primary benefits of the CRUT are:

1. Because the CRUT is a tax-exempt entity, there is no income tax due upon sale of the contributed business by the CRUT, enabling the sale proceeds to continue to grow tax-free and unreduced by the capital gains income tax that otherwise applies;

2. The grantor is entitled to an income tax deduction in the year of contribution equal to the projected charitable remainder value;

3. Similar to an installment sale, the income taxes due on the unitrust distributions are spread out over the years, enabling a greater portion of the trust funds to remain in trust where they grow on an income tax-free basis; and

4. The assets remaining in the CRUT at the grantors' deaths will escape estate taxation.

The combination of the up-front income tax deduction and the avoidance of the up-front capital gains income tax enables a much larger overall benefit to charitably inclined clients than otherwise would result. For example, assume business owner spouses ages 66 and 63 contribute a $5 million business to a CRUT, and retain an annual distribution of 10% of the trust corpus. When the business is sold, no portion of the $5 million realized gain is taxable, thereby avoiding the $1 million in 20% capital gains. Thus, the 10% unitrust percentage the grantors receive annually will be a percentage of the entire ($5 million) contributed value unreduced by income taxes, enabling a larger benefit than would otherwise result. Generally, the longer the business owners' live, the greater the benefit.

[18] The non-charitable payment may take the form of a fixed annuity or a unitrust (i.e., a fixed percentage of the underlying assets). Although similar in most respects, these materials focus on the unitrust. The CRUT option, by defining the annual payment as a percentage of the trust assets, better enables the business owner to proportionately benefit from the appreciation generated by a subsequent outside sale event.

2. **Post-Transaction Income Tax Considerations**.

a. Beware of the 3.8% net investment income tax (NIIT). The net investment income tax (NIIT) is a relatively new additional 3.8% tax on individuals, estates, and trusts effective for tax years beginning on and after 1/1/13.[19] The NIIT typically is not an issue when a business is sold by the owners, due to the material participation exception to NIIT.[20] However, if the owners have implemented pre-outside sale planning, the children of the owners (or other trustees and beneficiaries) may not satisfy any of the material participation tests.[21]

The use of trusts as recipients of pre-outside sale transferred interests (as opposed to direct transfers) may provide a planning opportunity for avoiding the 3.8% NIIT tax. In the much discussed recent Tax Court case *Frank Aragona Trust, et al. v. Commissioner*, 142 T.C. 165 (2014), the court held that the activities of three out

[19] The 3.8% tax consists of three separate taxes (FICA, SECA, and NIIT) that are effectively 3.8%. They are collectively referred to in this article as the 3.8% NIIT taxes.

[20] Pursuant to temporary regulation §1.469-5T, a taxpayer materially participates in an activity in a tax year if any of the following are satisfied:

(1) The individual participates in the activity for more than 500 hours during such year.

(2) The individual's participation in the activity for the tax year constitutes substantially all of the participation in such activity of all individuals (including individuals who are not owners of interests in the activity) for such year.

(3) The individual participates in the activity for more than 100 hours during the tax year, and such individual's participation in the activity for the tax year is not less than the participation in the activity of any other individual (including individuals who are not owners of interests in the activity) for such year.

(4) The activity is a significant participation activity (participation of more than 100 hours but no more than 500 hours) for the tax year, and the individual's aggregate participation in all significant participation activities during such year exceeds 500 hours.

(5) The individual materially participated in the activity for any five tax years (whether or not consecutive) during the ten tax years that immediately precede the tax year.

(6) The activity is a personal service activity (the fields of health, law, engineering, architecture, accounting, actuarial science or consulting, i.e. "professional services"), and the individual materially participated in the activity for any three tax years (whether or not consecutive) preceding the tax year.

(7) Based on all of the facts and circumstances, the individual participates in the activity on a regular, continuous, and substantial basis during such year.

[21] A common method of avoiding NIIT on undistributed trust income is to draft the governing document to be a grantor trust to the (active-owner) grantor. In the case of a grantor trust, each tax item included in computing taxable income of a grantor or another person under IRC § 671 is treated as if it had been received by, or paid directly to, the grantor or other person for NIIT purposes. See Reg. § 1.1411-3(b)(1)(v). Thus, if the grantor remains a material participant and is willing to remain liable for all trust income tax items, the NIIT can be avoided. This section of the materials assumes that the grantor either does not want grantor trust treatment, or grantor trust treatment to the grantor is unavailable (such as would be the case if the grantor is deceased).

of six co-trustees in the operation of an LLC (wholly owned by a trust) would be taken into account, and as a result, the trust satisfied the material participation test. The Tax Court did not, however, hold that all of the non-trustee fiduciaries, employees and agents could be considered in determining whether the trust materially participated, nor did it hold that the trustees' services to the business in other capacities (e.g., as employees) would be considered. Rather, the court found those determinations unnecessary since the trustees, acting in their fiduciary capacities as trustees, satisfied such test.

Although the IRS has not acquiesced to this decision, it provides support to the argument that if the trustees, in their fiduciary capacities, satisfy the material participation tests, so will the trust. However, be aware of (pre-*Aragona*) IRS technical advice memoranda 200733023 and 201317010, where the Service ruled that the appointment of an individual who is active in the business as a "special trustee" with only limited authority to act on behalf of the trust will not satisfy the material participation test.

> **Planning Tip**: Unfortunately, there appears to be no guidance as to whether all, a majority, or only one co-trustee must satisfy the material participation requirements in order to avoid the application of the 3.8% tax to the trust's income. While the Tax Court does not explicitly address this question, the Tax Court nevertheless found the Trust in *Aragona* Trust materially participated when only three of the six co-trustees (i.e., not a majority) were participating. Therefore, taxpayers may point to *Aragona Trust* as support where not all co-trustees are active in a trust's business. As a result, if a non-materially participating child (or other beneficiary) is designated as the trustee and beneficiary of a GST (or other) Trust, planners should consider whether appointing a co-Trustee who materially participates is effective to avoid the 3.8% tax.

b. <u>The Intentionally Defective Beneficiary Trust</u>. As discussed above, business-owner clients are often willing to establish trusts as grantor trusts so that the trust income tax liabilities are retained by the grantor. Doing so enables the trust assets to grow undiminished by income tax payments, and the tax payments by the grantor on behalf of the trust do not constitute additional (exemption using) gifts to the trust. Under current law, non-grantor trusts generally pay much higher income taxes because the highest rate bracket of 39.6% applies to undistributed non-grantor trust income in excess of $12,500, whereas such rate does not apply to individual income until it reaches $418,400. As a result, when clients wish to utilize trusts to accumulate income, far less income tax may result if the trust is a grantor trust for income tax purposes.

An IDGT is commonly established by reserving to the grantor powers under IRC § 675. Under § 675, a trust is characterized as a grantor trust whenever a

non-adverse party[22] acting in a non-fiduciary capacity, and without the approval or consent of any person acting in a fiduciary capacity, has the power to enable the grantor to reacquire[23] the trust corpus[24] by substituting other property of equivalent value ("Substitution Power"),[25] or (2) the power to enable the "grantor" to borrow trust corpus or income, directly or indirectly, without adequate security ("Borrowing Power").[26] The IRC § 675 powers are generally favored because they confer grantor status for income tax purposes without causing inclusion of the trust assets in the grantor's estate.

Although IRS Private Letter Rulings are only binding on and for the benefit of the taxpayer requesting the ruling (and cannot therefore be cited as precedent), there nevertheless are many Private Letter Rulings generally confirming grantor trust status for income tax purposes where the Substitution Power and/or Borrowing Power were present. *See, e.g.,* PLR 199942017 (grantor had both substitution and borrowing powers). *See, e.g.,* PLRs 200845015, 9504024, 9437022, 9416009, 9352004, 9248016 (grantor had substitution power[27]); PLRs 200840025, 9645013, 9525032, 8708024 (grantor had borrowing power); PLRs 199942017, 9446008, 9403020 (grantor had both substitution and borrowing powers). PLRs 200010036, 199908002, 9810019, 9713017 and 9407014 (nonadverse party had the substitution power).

However, in many cases, having the trust income taxed to the grantor is not a feasible option, or is not available due to the grantor's death. In such case, the trust may need to distribute out all trust income to enable income taxation at the (lower) individual rate brackets, or the trust may need to pay income taxes at the highest tax

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[22]Code §672(a) provides that the term "adverse party" means any person having a substantial beneficial interest in the trust which would be adversely affected by the exercise or nonexercise of the power which he possesses respecting the trust. Code §672(b) provides that the term "nonadverse party" means any person who is not an adverse party.

[23]Although the word "reacquire" may suggest that Grantor Trust status only results when the original trustors have the Substitution Powers, PLRs 199908002, 9810019 and 9713017 confirm that Substitution Powers granted to other persons (such as trust beneficiaries) can also result in Grantor Trust status.

[24]Code §675(2), and Code §675(4)(C) indicate that the form of the originally transferred assets may change or be altered without affecting grantor trust status, by their references to borrowing or reacquiring trust "corpus" rather than "the property originally transferred by the grantor." PLR 200842007 approved a Substitution Power enabling the grantor to "acquire ***any or all property constituting trust principal*** by substitution of other property of equivalent value…[emphasis added]" with respect to a trust where the trustees have broad powers to "invest, dispose of and otherwise deal with property in Trust, ***whether originally contributed to Trust, acquired by Trust or previously substituted into the Trust by Grantor***, without the approval or consent of any other person [emphasis added]."

[25] Code §675(4)(C).

[26] Code §675(2).

[27] The following Private Letter Rulings also confirm grantor trust status when a substitution power is present: 200910009, 200910008, 200729016, 200729015, 200729014, 200729013, 200729012, 200729011, 200729010, 200729008, 200729007, 200729006, 200729005, 200022048, 200022018, 200011012, 19942017, 19922007, 9719012, 9648045, 9645013, 9642039, 9616026, 9548013, 9525032, 9519007, 9505012, 9442012, 9440021, 9438025, 9437023, 9424032, 9403020, 9352017, and 9352007.

rate on a greater amount of the (non-grantor) trust income. The former option may not be in the best interests of the trust beneficiary, and/or may be contrary to the grantor's intent to accumulate income within the trust. The latter option is not ideal since it results in the highest income tax consequences.

An alternate possibility is the intentionally defective beneficiary trust ("IDBT"). An IDBT is the functional equivalent to the IDGT, except the trust income is taxed to the beneficiary rather than to the grantor. In other words, it is a grantor trust *to the beneficiary*. Although a "grantor" of a trust established by a third party for the beneficiary's benefit includes any person who makes a gratuitous contribution to the trust,[28] it appears likely that a beneficiary may take the position that all trust income will be taxed to her or him individually due to the combination of IRC §§ 675 and 678. Under IRC § 678(a)(2), "a person other than the grantor shall be treated as the owner of any portion of a trust with respect to which … such person has previously partially released … [a power to vest the corpus or the income therefrom in himself] … and after the release … retains such control as would, within the principals of sections 671 to 677 … subject a grantor of a trust to treatment as the owner thereof." In other words, if the beneficiary is granted a withdrawal right that is "partially released," and after such release the beneficiary continues to have a right under §§ 671 to 677 (e.g., the § 675(4) Substitution Power or § 675(2) Borrowing Power), the trust income is taxed to the beneficiary under 678(a)(2).

For example, in PLR 201216034, the current trust beneficiary (but no other person) had both a Substitution Power over 100% of the trust corpus and a cumulative power to withdraw from the trust corpus ("Withdrawal Power"), and the Withdrawal Power partially lapsed annually as to the value that did not exceed the greater of $5,000 or 5% of the value of the trust. In such case, the beneficiary was treated as the sole owner of the trust for federal income tax purposes.[29] Under the Services' reasoning in PLR 201216034, if the trust document grants to the trust beneficiary (1) the Substitution Power and Borrowing Power over all of her or his trust assets, and (2) a second annual Withdrawal Power which can be exercised, in cash or in kind, out of any of the assets in that beneficiary's trust, then 100% of the assets of

[28] §1.671-2(e)(1) of the Income Tax Regulations provides that for purposes of subchapter J, a grantor includes *any* person to the extent such person either creates a trust, or directly or indirectly makes a gratuitous transfer of property to a trust.

[29] PLR 201216034 provides: "Section 678(a) provides, in general, that a person other than the Grantor shall be treated as the owner of any portion of a trust with respect to which (1) such person has a power exercisable solely by himself to vest the corpus or the income therefrom in himself, or (2) such person has previously partially released or otherwise modified such a power and after the release or modification retains such control as would, within the principles of §§ 671 to 677, inclusive, subject a Grantor of a trust to treatment as the owner thereof… Based solely upon the facts submitted and the representations made, we conclude that, Primary Beneficiary will be treated as the owner of Trust under Section 678(a)(1) of that portion of Trust over which his withdrawal power has not lapsed. To the extent that Primary Beneficiary fails to exercise a withdrawal power and the power lapses, Primary Beneficiary will be treated as having released the power, while retaining a power of administration, exercisable in a non-fiduciary capacity, to acquire Trust corpus by substituting other property of an equivalent value."

each trust are made subject to the Powers granted to that trust's primary beneficiary, and all trust income should be taxable to the beneficiary.[30]

However, assets subject to a general power of appointment (*e.g*., an unrestricted withdrawal right) are generally included in the taxable estate of the powerholder, and are exposed to the claims of the powerholder's creditors. To limit the exposed amount, consider making the annual Withdrawal Power lapse at the end of each year (similar to the lapsing part of the withdrawal power in PLR 201216034), other than a relatively small amount (*e.g.*, $1,000).[31] That smaller amount of each such annual Withdrawal Power may accumulate and be withdrawn in future years (similar to the cumulative part of the withdrawal power in PLR 201216034).[32] Most importantly, no person other than the respective beneficiary has a Substitution Power, Borrowing Power or Withdrawal Power which would result in that person being another "owner" of the trust for income tax purposes (also similar to PLR 201216034).

> **Planning Tip:** If the trust beneficiary is also a material participant in the business, implementing the IDBT income tax method may provide the best of all worlds: So long as the trust income is taxable to the beneficiary, the trustee material participation issues left open by *Aragona Trust* become irrelevant.

[30] Although the PLR 201216034 beneficiary initially had no maximum dollar amount applicable to the power to withdraw the trust corpus, since no other person had the Substitution Power or Withdrawal Power over any portion of the trust corpus, there appears to be no reason why PLR 201216034 would be decided any differently even if that withdrawal power had been limited by a maximum dollar amount. Accordingly, planners should analyze whether the 678(a)(1) power can be limited to a smaller portion of the trust income (so long as the 678(a)(2) power is with respect to the entire trust).

[31] If the trust is drafted so that no lapse of the Withdrawal Power can exceed the "5,000 or 5%" rule of § 2514(e), there can be no present gift tax consequences to the beneficiary when part of the Withdrawal Power lapses, nor is any such lapse a "transfer" for purposes of Code § 2036 or § 2038 which would cause inclusion of the Trust in their taxable estate. However, any Withdrawal Power that has not lapsed by the beneficiary's respective death will be included in the taxable estate (for example, if the beneficiary lives another 60 years, this amount (if not withdrawn by her prior to death) would cause $60,000 to be included in her estate). Code § 2041 (b)(2); Reg. § 20.2041-3(d)(3).

[32] As noted above, for a beneficiary to be deemed the owner of a trust (for income tax purposes) under IRC § 678(a)(2), if such beneficiary's Withdrawal Power is "partially released," the beneficiary must retain a power over the trust that would render it a grantor trust with respect to the real grantor (if the real grantor had retained such power). It thus appears that if the power gradually lapses in its entirety (by $5,000 / 5% per year), IRC § 678 status is lost. However, PLR 200949012 indicates that this is not the case. The ruling apparently treats a "lapse" as a "release" so that even if the unilateral right to withdraw eventually disappears (by $5,000 / 5% per year), the lapse would be partial only because the general power to withdraw assets for the beneficiary's health, education, maintenance and support remains present. This general distribution power – if it had been retained by the grantor – would be a grantor trust trigger under IRC § 677. Thus, under IRC § 678, the beneficiary continued to be treated as the owner of the trust. That said, the "partial release" language of IRC § 678 leads us to believe that including a "true" partial release of the Withdrawal Power is the safer approach.

3. Miscellaneous Considerations:

a. Unequal Child Involvement in the Business: A common issue with business-owner clients is that at least one, but not all, of the children are active in and/or equipped to take over the business operations. In that case, clients are often faced with the decision whether to treat their children unequally, or to attempt to otherwise compensate the other child(ren) at death with a larger share of other assets to offset the difference. If the client is insurable, insurance proceeds are a source of funds by which the clients can "equalize" the shares. If the clients are not insurable, careful thought must be given to how best to implement a gift and inheritance strategy that best accomplishes the clients' goals with respect to the ongoing operations of the business, but also minimizes the chances that the children's relationship will suffer due to perceived inequalities in treatment.

b. Maintaining S Corporation Status: In making any pre-outside sale estate planning recommendation (particularly those involving trusts), it is critical that the estate planning attorney is mindful of any corporate entity that has made an "S-election." Generally speaking, S corporations avoid the corporate level of income tax imposed upon C corporations, meaning only the shareholder's pay income tax on their proportionate share. The class of persons who may own stock of an S-corporation is far more restricted than the class of permissible C corporation shareholders. For example, only certain types of trusts (e.g., Qualified Subchapter S Trusts and Electing Small Business Trusts) may hold S corporation stock. Failure to include these considerations into any transfer plan can result in substantial (otherwise avoidable) income tax.

c. Assignment of Income Doctrine: Very generally speaking, the assignment of income doctrine can be implicated by gifts of entity interests that occur shortly before a sale of the business. For federal income tax purposes, when a sale of property is certain to occur and the seller gifts the property prior to closing, the seller/donor (rather than the donee) may be taxed on the sale for income tax purposes, and is deemed to make a gift of the sale proceeds.[33] Thus, a transfer very close in time to an outside sale can not only have the effect of fixing the value of the gifted interests at the sale price, but can also result in the seller retaining full responsibility for all income tax despite his or her intent to shift income to the recipients (who often are in lower income tax brackets). However, the mere anticipation of income at the time of the gift does not cause the seller/donor to be taxed.[34] The analysis of whether the sale is certain at the time of the gift is a fact-driven analysis, but generally speaking, if there are outstanding contingencies at the time of the gift, the gift is more likely to be respected for tax purposes.

[33] See, e.g., *Salvatore v. Comm*., 434 F2d 600 (2nd Cir. 1970).

[34] See, e.g., *Haley, James v. U.S*., 400 F Supp. 111 (DC GA 1975), *Brock, Clay*, 22 T.C. 284 (1954).

d. Basis step-up at death: Under Code § 1014, the assets owned by a decedent at death receive a cost basis "step-up" to fair market value. Because Washington State is a community property state, our residents receive a double basis step-up that increases the basis of not only the deceased spouse's share of the property, but also the surviving spouse's share.[35] In contrast, the separate property of the surviving spouse does not receive the basis step up. Due to the basis step-up rule, significant capital gains income tax liabilities can be avoided if the business interests are sold after the death of the owner. As a result, income tax savings resulting from a basis step-up must be compared with the projected estate tax savings that should result from any pre-death (discounted) gifts.

Example #4. Assume married clients have a combined $10,258,000 estate, which consists of $1.258 million in cash and a $9 million business with a cost basis of zero. If the clients gift the business out of their estate so that they only own the cash at the death of the surviving spouse, they will save roughly $890,000 in estate taxes. However, when the business is sold by the estate or the heirs, the income tax due will be between approximately $1.8 million and $2.142 million (depending on the applicability of the 3.8% NIIT). In such case the clients' heirs will incur over $1 million more of capital gains taxes so that the estate could save $890,000. In contrast, if the assets are simply retained until death, the estate will pay the $890,000 of estate tax, but the $1.8 - $2.142 million of income tax at the estate or beneficiary level is avoided. It is thus a more advantageous approach in this case to delay transferring the business until after the first death (at least) so the heirs receive the benefit of the basis step up.

e. Post-Sale Liquidity Issues: IRC § 6166 is a Code section intended to provide business owners estate tax relief when a large portion of the estate consists of active closely-held business interests. Specifically, if the estate qualifies under IRC § 6166 as being comprised of more than 35% of active closely-held business interests, that Code section allows the executor to elect to defer payment of the estate tax for up to five years after the decedent's death and to pay the tax in installments for up to ten additional years thereafter. Thus, the estate may stretch the installment payments of estate tax (and interest) over a period of up to 15 years.

However, if the client has sold its business assets and instead holds a promissory note at death, the client likely no longer qualifies for IRC § 6166 deferral. If the promissory note does not accelerate payments upon the client-seller's death, the estate will have to include the promissory note, but may not have the liquidity to pay the estate taxes imposed on the present value of the remaining payment stream. Planners should consider if their clients are insurable for liquidity-producing life insurance to hold outside of the taxable estate in a tax-exempt trust. In that case, if death occurs post-outside sale, but prior to receiving the bulk of the purchase payments, the trust may loan the funds to the estate to enable timely payment of the estate tax-liability.

[35] IRC § 1014(b)(6).

f. Review Documents After the Sale: It is common for clients' Wills or other testamentary documents to direct the business interests in a different manner than the non-business assets. For example, business interests may be allocated all to one child, with the other assets allocated to the other(s), or the business interests could be allocated all to one child with the non-business interests allocated equally amongst all of the children. The estate planning attorney should review the clients' estate plan following an outside (or intra-family) sale to confirm they still reflect the clients' intent. It is possible that the client still wants the sale proceeds to flow to the beneficiary who would have received the business assets had they been retained. It is also possible that sale proceeds could be treated as "non-business" property that is split equally. Reviewing the documents and making changes (if necessary) to expressly address this issue can prevent a protracted dispute over otherwise (arguably) ambiguous provisions.

g. Federal Repeal: President Trump's tax plan generally calls for a repeal of the federal estate tax, but proposes a tax on capital gains held until death to recoup lost estate tax revenue. However, the Trump proposals are light on details. For example, although an exemption for the first $10,000,000 of built-in gain has been proposed, it is unclear if this is per individual or per couple. It is additionally unclear if the $10,000,000 of exempted gain retains a basis step-up at death, or if those gains will be subject to a transferred basis regime.

On January 24, 2017, five Republicans and one Democrat introduced H.R. 631, the "Death Tax Repeal Act of 2017," and Senator Thune, with 31 Republican Senators co-sponsoring, introduced very similar legislation with the same title, S.B. 205, in the Senate. In the weeks prior, three much simpler estate tax repeal bills were introduced in the House, H.R. 30, H.R. 451 and H.R. 198; the latter also being referred to as the "Death Tax Repeal Act of 2017. Both S.B. 205 and H.R. 631 retain the gift tax at 35% while eliminating the estate and GST tax. H.R. 30 and H.R. 198 would simply eliminate estate, GST and gift tax altogether. H.R. 431 would only eliminate the estate tax and touches neither GST nor gift tax.

In this author's opinion, the planning strategies described in these materials will in most cases remain advantageous even if the federal estate tax is repealed. First, due to revenue constraints, it appears highly unlikely that the state estate tax will be repealed (or made more taxpayer-friendly) at any time in the foreseeable future.[36] As a result, the continued imposition of the Washington State estate tax and the lack of a state gift tax will continue to make gifts an effective state estate tax reduction strategy. Second, if transferred basis is enacted at the federal

[36] In *McCleary, et al. v. State of Washington*, 173 Wn.2d 477, 269 P.3d 227 (2012) the Washington State Supreme Court ruled that the state legislature has failed in its constitutional duty to fund public schools. The court ordered the legislature to meet its constitutional obligation by 2018. The legislature has since been found in contempt of court for failing to make adequate progress towards that funding. Any legislation that decreases tax revenues appears contrary to the *McCleary* court's order. It is even possible that Washington will increase its estate tax to absorb all of the federal estate tax savings resulting from the federal repeal, similar to State Senate Bill 726, already introduced in California.

level, there will be no income-tax disincentive for Washington State clients to shift assets out of their Washington taxable estate (in fact, assuming that children are in lower-income tax brackets, federal income tax and Washington State estate tax reduction goals will both be served by making substantial lifetime gifts). Third, despite its frequent detractors, the estate tax is a well-established component of federal tax law: Other than the recent one-year 2010 repeal, the federal estate tax has been in continuous existence since 1916. It thus seems very possible (if not likely) that even if repealed during the Trump administration, the federal estate tax will be re-enacted again at some point in the near future.

4. **Conclusion:**

The planning methods discussed in these materials must, in some cases, be addressed years in advance of an outside sale of a closely-held business. However, with timely planning, the owners of a closely-held business can (1) transfer significant value to succeeding generations in a manner that substantially reduces the owners' taxable estates for estate tax purposes, (2) maximize the value of gift, estate and GSTT exemptions, and (3) leave the transferee trusts in the best income, estate and GSTT situations available under current law.