The Silver Lining Playbook: Estate Planning Opportunities For Business Owners In A COVID-19 World

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John F. Kennedy once said, "The Chinese use two brush strokes to write the word 'crisis.' One brush stroke stands for danger; the other for opportunity. In a crisis, be aware of the danger–but recognize the opportunity." While entrepreneurs are great at identifying opportunity, the successful ones are those who can keep their wits about them during a crisis and find the opportunity to succeed while others fail. Tragic as this COVID-19 crisis is, it does present rather unique opportunities for successful business succession – especially within family businesses.

Aside from the emotional and the strategic issues that must be addressed in transferring a business from one generation to the next, one of the most complex issues is navigating the federal gift and estate tax laws in an efficient manner to maximize the amount of wealth that can pass to the succeeding generation tax-free. The Federal estate/gift tax exemption is currently pegged at $11.58 million. This is the amount that any individual can pass tax-free during life and at death, in the aggregate. This exemption is indexed, so the exemption has been increasing each year for several years, and there was a doubling of the exemption in 2018 as a result of the tax law enacted the previous year.

However, the increased exemption provisions of the TCJA are scheduled to sunset at the end of 2025, effectively cutting the exemptions in half. Nevertheless, the IRS announced in 2019, that if an individual uses his or her entire exemption through lifetime gifting prior to 2026, there will be no "claw-back" of the excess exemption when the exemption is halved. Unless you are certain that Congress will extend the increased exemptions that were established under TCJA, the time between now and Dec. 31, 2025 must be utilized to take advantage of the additional available exemption.

Confluence of events

Why does this COVID-19 crisis present opportunities? First, valuations of businesses, which affect the amount of exemption used for any gifting, have likely been significantly reduced as a result of the economic slowdown. Second, interest rates, which are relevant to any gift tax planning analysis, are at historic lows. Third, Congress' stimulus programs have pumped an extraordinary amount of money into the economy, which often leads to inflation. Fourth, we have a presidential election in November, which could result in flipping the political party in control. And, finally and perhaps most important, with the amount of stimulus spending in Washington, there is a significant increase in the federal deficit. Ultimately, that bill will need to be paid. This makes the likelihood of a sunsetting of the tax code's increased exemption much greater and calls into question whether the exemption will be further reduced by an act of Congress to generate income.

What follows is a discussion of some of the gift/estate planning techniques that business owners must consider for business succession purposes.

Gifts of business interests

Assume that Robert (age 75) is the sole owner of a widget manufacturing company with average annual revenues over the past three years of $12 million. The widget company employs three of Robert's children, and they are all valuable to the continued success of the venture. In late March, and continuing through April 2020, revenue drops by 75 percent due to COVID-19 — a pandemic with no certain outcome. Before the outbreak, the value of the business was approximately $60 million. The pandemic has shaken Robert and his wife, Judy, to their core. They want to leave New Jersey and spend more time in Florida, after they have been given the all-clear to head south.

Robert decides now would be a good time to give the business to his kids. An updated valuation of the company now pegs the value at $45 million, which reflects a 25 percent decrease due to the COVID-19 crisis. He and Judy decide that they are going to give each of their three children a 25 percent interest in the company. As a result of discounts for lack of marketability and minority ownership of 35 percent, the appraisal of each of these 25 percent interests is valued at $7.3125 million. Thus, Robert and Judy have given away just under $22 million in total and through the use of their lifetime exemptions, they have paid no gift tax.

The business bounces back in value and appreciates beyond what it was worth prior to the COVID-19 crisis. Judy dies in 2026, one year after Robert's death, and after the increased estate tax exemption has sunset. The value of the business is $75 million at the time of Judy's death. The estate tax savings as a result of the timely gift could be as high as $15 million, assuming a 40 percent tax rate.

The lesson of this hypothetical is that it is prudent to take advantage of opportunities when assets drop in value but are expected to rebound. Having the asset appreciate after the gift, while the bulk of the business interests are already owned by the next generation, can produce significant estate tax savings opportunities. In addition, the advantage of utilizing discounts on gifts of minority interests is lost if the entire interest in the asset is held by the founder until death.

Sale or trust

In addition to reduced valuations of assets due to the pandemic, interest rates are at historic lows. For purposes of gift taxation, on a monthly basis, the IRS publishes minimum rates that must be used in loan transactions between family members. These rates are referred to as the applicable federal rates. The recently published AFRs for May 2020 are as follows: Short term (3-year term or less); 0.19 percent; Mid-term (3-year to 9-year term); 0.44 percent; Long term (9+ years) 0.87 percent.

In the above example, if Robert had already used his estate/gift tax exemption, or if he simply wants a stream of income and wishes to sell the business to his kids rather than give it to them, he could sell it in exchange for a note utilizing these historically low rates. If the business grows in value in excess of the interest rate imposed on the note, that differential between the growth and the AFR will benefit his children free of any gift tax.

Assume, however, that Robert doesn't want to pay capital gains on the sale of the business. Instead, he could establish a trust for the benefit of his children, and reserve certain powers within the trust which will cause the trust to be treated as a "Grantor Trust" for income tax purposes. This designation means that the trust becomes the alternate identity of Robert for income tax purposes, even though the trust is not considered as Robert's asset for estate and gift tax purposes. Because Robert has sold the asset to his alternate identity, no capital gain is recognized.

The trust provides several other benefits. Chief among them is that because the trust is the alternate identity of Robert for income tax purposes, any income from the business flowing through to the trust as the owner will be reflected on Robert's income tax return. When Robert pays that income tax, he has, for all practical purposes, made a gift to the trust by satisfying the obligation that would otherwise belong to the trust. For gift tax purposes though, this payment of the income taxes is not considered a taxable gift. This combination of low rates and tax-free growth can result in significant passage of wealth between generations in a very tax-efficient manner.

Gift to a GRAT

Another type of Grantor Trust is a Grantor Retained Annuity Trust. A GRAT is an irrevocable trust which provides that, for a pre-established period of time, the trust will make a stream of payments (an annuity) back to the Grantor of the trust, and that at some predetermined time when the annuity ends, the balance in the trust will be available for future generations. The use of a GRAT can be a very effective means of transferring wealth while consuming little, if any, gift tax exemption. When the Grantor of the trust designs the trust, he or she can set the stream of annuity payments determined by deciding how much gift tax exemption the Grantor wishes to use.

For gift tax purposes, the value of a gift to a GRAT is the difference between (i) the value of the assets donated to the trust, and (ii) the present value of the stream of annuity payments. The interest rate to be used for determining the value of the annuity is known as the "7520 rate," and it is published by the IRS on a monthly basis. The IRS recently announced that the 7520 rate for May is at a historically low 0.80 percent. In effect, this is the rate that the IRS assumes the trust will earn going forward.

Looking back at our hypothetical set forth above, if Robert were to donate half of his interest in the business to a GRAT today, he will be gifting an interest valued at $22.5 million based upon the recent appraisal. Robert feels that his business will eventually come back, but it could take 5 years to do so due to the pandemic. Robert directs his attorney to draft the trust to provide Robert with an annual payment at the end of each year, in the following amounts:

May 2021 $ 3,105,373.50

May 2022 $ 3,726,447.75

May 2023 $ 4,471,735.50

May 2024 $ 5,366,081.25

May 2025 $ 6,439,297.50

Total payments to Robert $23,108,935.50

The present value of the stream of payments to Robert, utilizing a 7520 rate of 0.80 percent, is $22,499,983.69. That means that the value of the taxable gift that Robert has made is $16.31 ($22,500,000 – $22,499,983.69). In other words, for all practical purposes, Robert's stream of payments is roughly equal to what he has put into the trust. So where is the value in this strategy?

If the business truly does appreciate back to its pre-pandemic value in 5 years, it will have appreciated at an annual rate of approximately 8.5 percent. The difference between that rate of growth, and the 0.80 percent return that is given to Robert in the form of an annuity, is 7.7 percent. That difference in rate of return belongs to the trust for the benefit of Robert's children and, in this example, that amount is $7,243,180.98. That is the amount that would remain in the trust at the end of the five-year annuity period, and Robert will have used up only $16.31 of his lifetime gift tax exemption, effectively allowing Robert to make a tax-free gift of almost $7.25 million.

The beautiful feature of the GRAT is that even if the assets only grow at 0.80 percent rate, or if they, in fact, decrease in value, Robert will be in no worse shape than had he done nothing. He would be back in the same position, having received back all the shares of the company in the form of an annuity, and he will have only consumed $16.31 of gift tax exemption. While he wouldn't be happy, he would just be back where he started.

These are unprecedented times, but there are silver linings if you look for them. For business owners who are undoubtedly struggling, now is the time to plan for the future rebound of the business, and the time to find the opportunities to plan well. No place is that more true than in connection with a business succession.

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NJBIZ Silver Linings Playbook PDF.