Speaker 1: (00:03)
Welcome to the Vandenack Weaver legal visionaries podcast brought to you by interactive legal here's your host Mary Vandenack

Speaker 2: (00:12)
Welcome to today's episode of Vandenack Weaver, legal visionaries, a weekly podcast discussing updated legal news, evolving methods of providing legal service and law practice issues. My name is Mary Vandenack founder and managing partner at Vandenack Weaver, LLC. I'll be your host. As we talk to experts from around the country about closely held business tax trusts and estates, legal technology, law firm, leadership, and wellbeing. Before we start today's episode, I want to thank our sponsor. Here's the message from interactive legal.

Speaker 3: (00:51)
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Speaker 2: (01:40)
Currently, we're doing a series of episodes talking about business, exit planning, and for the series of involved my partner, Mike Weaver, to discuss some of the techniques that we use when business owners are considering, considering exiting their business. In a previous episode, we talked about considering what you need to do at the business level before a sell today, we're going to talk about some of the trust strategies. So, we always kind of go through level one is let's look at the business. Let's figure out where you're at, what your structure is, what's going to be tax efficient. And then we shift to saving taxes on the transaction. And we look at both the state taxes and income taxes. When we start to consider that it's kind of, as we talk through some of these trust techniques where the helpful concepts are just to clarify a couple of the references that people will hear about types of trusts. And one of the types of trusts that is referred to is what's called a grantor trust. Might you give us a quick overview on what is meant by a grant or trust?

Speaker 4: (02:44)
Sure. I think it's important to from the, from the start recognize that a trust is a separate legal entity. So, it's, it's separate from, from a legal standpoint, it's separate from you. It's separates me. If I set up a trust, it's, it's separate from me for tax purposes. That's not always the case. And that's where a grant toward trust can come in. So you mentioned the two different,

Speaker 2: (03:09)
So income tax or estate taxes. Are you going to make that distinction for me? Okay,

Speaker 4: (03:14)
So you, you mentioned the fact that there are income taxes and there are a state taxes and those are two different things. So, what a grant toward trust does, it is treated differently for income tax purposes than it is for estate tax purposes. A grantor trust for income tax purposes is what we would call disregarded in the tax biz. So that means if I set up a grantor trust and I'm the grand tour, the creator of the trust that trust for tax purpose for income tax purposes is disregarded. So, for example, let's say that trust that grant or trust that I set up owns a hundred shares of Tesla and Tesla kicks off a dividend of $50.   that $50 is taxed to me individually on my personal income tax return. So, the trust doesn't pay the tax because it's disregarded for income tax purposes. I pick that up on my return.

Speaker 2: (04:10)
And so that could be true, where, where you said is like we could have different treatment for income and estate tax purposes, but it is also possible. You have kind of a basic revocable trust that a lot of people will set up as sort of a foundational estate plan where it's almost their alter ego. They might be their own trustee and that all that income is going to continue to flow through to me. But that particular entity will be included in my estate. Right?

Speaker 4: (04:35)
So the difference with the grant toward trust is like, like we were saying, it's an, it's a disregarded for income tax purposes, but it's regarded for estate tax purposes for estate tax purposes. It's not,

Speaker 2: (04:49)
Is this usually an irrevocable trust versus my example of the rev? So, we have the revocable trust, which is I set one up. I can get rid of it. I can d,p it. This one is going to be taxable to me for income tax purposes and included in my estate, correct. Then we have an irrevocable grantor trust. And now that trust is going to be taxed to me for income tax purposes, but not included in my estate.

Speaker 4: (05:14)
If the, if that grantor trust is set up properly. That's correct. So, and go back to my example of my a hundred shares of Tesla for income tax purposes, it's going to be included as part of me, but when I die that a hundred shares of Tesla is not going to be included in my estate.

Speaker 2: (05:32)
So what's the advantage of that?

Speaker 4: (05:34)
Well, the advantage of that is I can,   remove, I can remove things from my estate at hopefully a very reduced either a state or, or really a gift tax costs.

Speaker 2: (05:47)
And you're continuing to pay the income taxes on it, which when you pay those income taxes, is that a gift for gift and estate tax purposes

Speaker 4: (05:57)

For tax purposes? No.

Speaker 2: (05:59)
So I'm leveraging basically I'm making a gift without making a gift. So, if I'm really trying to reduce my estate, this is a way of leveraging. So, I put $10 million in this irrevocable trust. I'm still paying the income tax. A lot of grantors don't like that though, right? Even if they have lots of money that they're trying to give away, it's like, wait a minute. I put this $10 million in a trust. I don't have access to it. I'm still paying the taxes on it.

Speaker 4: (06:24)
People do not like to pay taxes, but you got to, it's hard to point out to them. Yeah. But what you're really doing is you're making a further gift by paying that tax because the tax burden is not on, you know, on your kids or whoever you might've given that stock to.

Speaker 2: (06:37)
So it's a leveraged way of continued gifting. So, one of the common presale strategies that we see used is what the acronym is grad and GRA refers to grantor retained annuity trust, right? Can you give us a sort of elementary version explanation of what a gratis and when a business owner should think about it and maybe that's two separate questions?

Speaker 4: (07:02)
Let's yeah. Let's just what a grad is first. So, a grad is one of those irrevocable trust that is structured as a grantor trust. And basically, what you're doing is your putting property into that trust. So, go back to my example, you're going to put a hundred shares of Tesla into that trust. Normally that's going to, because it's an irrevocable trust that's going to, it can be considered a gift for gift tax purposes. So, I just made a gift of a hundred dollars or a hundred shares of Tesla to whoever the beneficiaries of that trust are. But the way the grad is the way the grad transaction works is I take back an annuity payment that is equal to the value of that a hundred shares of Tesla that I put in there. So, for gift tax purposes, it's a net zero, right. I put a hundred dollars in, and I take a hundred and I take a hundred dollars annuity back out. So even though it's a gift, it has, it's, it's a valueless gift because, because I netted it out through the,

Speaker 2: (08:01)
So you don't have to use apps. So currently people have in the ed little, an excess of 11 million, I think it's almost 12 this year to use as a gift tax exemption. And what you're saying is when you fund a graft, a graft in the manner that you have just described, I'm using none of that exclusion, but normally if I were to give you $50,000, 15,000 of that is eligible for an annual exclusion, right. But I've made you a gift of the difference, right? And so, then I'd have to file a gift tax return and report that gift that I made to you. Right. But if I put this into a grant and this is what we refer to as a zeroed out, correct? Correct. Do I have to file a gift tax return?

Speaker 4: (08:43)
You should still file a gift tax return because you're, you know, even though it's a net zero gift, there is a value of a gift that you're making. You're just taking an annuity back to zero it out.

Speaker 2: ([08:55]())
And so if I'm taking this annuity back to

Speaker 4: ([08:57]())
Zero out, why am I bothering? That's a good question. And this is, this is kind of what we call it. An estate freeze technique. Cause really let's look at what it's doing. So, I'm taking that a hundred dollars out. So immediately after the transaction, I'm no better off than when I, when I did the transaction, I got rid of a hundred dollars. I got rid of a hundred-dollar asset, but I took a hundred-dollar asset back. So, my estate hasn't changed anything. I haven't accomplished anything. The goal that you have though is, ,, the, the asset that you put into the grant, you hope is going to appreciate more than the required annuity payment. So, the annuity payments can be paced on some interest rate. And you hope that the, that the, uh, that the value that the value that the asset grows faster than interest rates. So, go back to my example, I put a hundred shares in and it's worth a hundred bucks and it's a two-year grant. Let's say at the end of that two years, if the value of that a hundred shares is now instead of a hundred bucks, it's 150 bucks. I just got 50 bucks out of my estate and into the hands of my beneficiaries without paying any transfer tax on that. That's, that's the play that you're trying to make.

Speaker 2: ([10:10]())
If I put some apple stock into a gret in say 2019, and then at the end of the two years, then that's where I don't remember. I think Apple's talk is the value of that's gone off the charts, but that's the perfect example of where this technique works. When does it fail?

Speaker 4: ([10:29]())
Well, when the value of that asset goes down, what goes down is when it fails. And that's why a lot of people like these shorter-term two-year grads, because then they're not locked into it for a long period of time. And hopefully if there is a loss, it's maybe not that significant, but from a business sales standpoint, you know, if you're gonna, if you're gonna, if you're going to have a transaction where you think the value of your business is going to go up, say in the next couple of years, you know, and again, this is where forward thinking comes in handy. If you're, if you're thinking of, if you're contemplating selling your business, if I put, if I fund the grant, you know, before I've got a real potential purchaser on the line and that's maybe driving the value up, or if I think, you know, in the next two years, I know I'm going to have, uh, just two great years. That's gonna really increase the value of my company. If I do this grant now in two years, when I sell the thing and the price is a multiple of five or six times higher than what you know, I originally, when I first set the thing up, I've just gotten a tremendous amount of wealth to my ears without, without paying any transfer tax on it.

Speaker 2: ([11:37]())
And that's where it's a great strategy. That's where it's

Speaker 4: ([11:39]())
A good strategy for, , for someone who's thinking about selling their business.

Speaker 2: ([11:43]())
We are going to take a brief break from our episode for a word from one of our sponsors, Carson,

private client wealth planning focuses on liquidity management

Speaker 5: (11:53)
And charges you a fee based on a percentage of your assets. But entrepreneurs typically invest in their business resulting in light liquidity. That requires a unique strategy at Carson private client. We provide a proactive and holistic strategy for building and protecting your wealth. Our mission is to alleviate the stresses and the burdens of coordinating all those financial strategies. Carson, private client will work with your current team of advisors to customize a strategy that manages all aspects of your life and wealth, giving you back the time to focus on what matters most complex needs require sophisticated solutions. Reach out to our office at 4 0 2 7 7 9 8 9 8 9 to schedule your consultation. Investment advisory services offered through CWM LLC, and sec, registered investment advisor.

Speaker 2: (12:50)
Okay, let's continue our episode. So, another strategy that we use, and I always love our acronyms. And so, this one we call an exit and exit means intentionally defective, grantor trust. Can you give us a brief explanation of, I know brief is impossible when it comes to describing an exit? So, can you just give us an explanation of what an edge it is?

Speaker 4: (13:13)
So it's not dissimilar from the grad, in that year, it's a, it's a freeze technique. So again, you're setting up an irrevocable trust. It's set up as a grant toward trust. ,, you, instead of making, instead of putting an asset in and taking an annuity back, you're basically putting an asset in, you're selling the asset to the exit and you're taking back a note equal to the value of the property that you sold. And in that way, you're zeroing out the value of the gift. So technically what I do is I sell a hundred dollars' worth of stock to my and I take a a hundred dollars promissory note back.

Speaker 2: (13:54)
So let's say I do that with $10 million. So let's say have some stock and it's valued at $10 million. Now there's this whole thing that we hear about called discounting when I sell this to my exit. So, I create an exit and I have $10 million of stock. Am I selling it for $10 million, the fair market value, or am I allowed to take any discounts on that and sell that for say 7 million, 500,000, right?

Speaker 4: (14:23)
And the answer to that is probably, but it may depend, for example, if I'm selling Tesla stock, you know, I'm probably not going to get a discount on that because it's, it's readily tradable on

Speaker 2: (14:33)
Sign non-voting stock in closely held company that owns franchises across the country.

Speaker 4: (14:39)
Yeah. That's, that's going to be eligible because elbow eligible for some discounts because it is non-voting. So, they don't have, you know, whoever, when I sell that whoever's going to buy it is going to have no control over it because it's non-voting stock. So, they're going to say, I'm not going to pay you the exact fair market value. I want some discount off that fair market value because I can't control what

you're selling me. So, you'll get it. You can get a discount for that. You can get a discount for lack of marketability, meaning unlike Tesla, I don't have a red already market where I can just go out and whenever I want to liquidate sell it, it's harder to sell so I can get a discount for that too. So, depending on how that gift, what, what that gift is, and maybe how it's structured, you will be eligible to take some discounts, or you may be eligible to take some discounts. So that further enhances the tax savings because now instead of, you know, you've got a million dollar gift or a $10 million gift, but you were able for transfer tax purposes value at, at seven and a half million, but in, but, uh, you know, from your standpoint, it was a $10 million gift

Speaker 2: (15:43)
And we can generally do the same thing with the grass. So, I want to kind of back up to saying, we have this grant thing and we have this image its thing. And so, when do we use a graph versus edges? So, in this graph that I've got this absolute annuity payment that I must make, and if I don't have cash in there to make that payment, what do I have to do?

Speaker 4: (16:04)
Well, what you're really doing, if you don't have the cash in the grass, if you don't have the cash to make that annuity payment, you're really transferring back part of the shares, to, to the, to the grantor of the trust. So, if I create the trust and I put a hundred chairs in it, and just for simple math, the first-year annuity is $50. And the second-year annuity is $50. And at the end of the first year, there's no cash in there. It's just a stock and let's say it hasn't gone up in value. Then you're just going to transfer me back $50 worth of stock to pay that annuity.

Speaker 2: (16:36)
And the goal is really to have the stock stay in there. So, we really would prefer, so is it better to have some type of stock that is paying dividends or some throwing off some cash to pay that annuity?

Speaker 4: (16:49)
Yeah, it can be just keeping in mind that it is a, it is a grant or a trust. So, any of the, any of the dividends that it's kicking off is going to be taxable to the grantor of that trust.

Speaker 2: (17:02)
And so the images, what's the advantage of the idiot and the note,

Speaker 4: (17:06)
Well, the agent and the note, Hey, it, it gives you a little more, you can do a little more, long-term planning with it. Like I said, with the Grad, the zeroed out short-term grants are popular because they do kind of reduce the risk of the, the asset going down, ,, with the, with the edge that you, you're not that concerned. Maybe isn't there quite so much. So, you can do some longer-term planning. You can stretch out that, those payments and make that a little more palatable. So that, for example, you don't have to transfer back stock and you get to keep the asset in the, in the agent.

Speaker 2: (17:38)
And the typical involves a part gift parts sale, and there's commentators vary on how much they think

you should have go in as what we call seed capital. Right.

Speaker 4: (17:51)
I think the general rule is about 10%. So, if you want to make a million-dollar gift, data have, a hundred grand in there already. ,, and you're going to probably

Speaker 2: (18:02)
Wait. So, is that a hundred thousand gifts? And then the rest of that is sale, or I just want to clarify that structure.

Speaker 4: (18:09)
Yeah. It would be if you're putting a million dollars in what the IRS wants you to have is 10% of that sort of this,

Speaker 2: (18:18)
And we made a gift of 10%. Right. And then the note is for the rest of that. Right. Okay. So, and another thing that's kind of gone on and do you have any other thoughts? I was going to shift to some of the income tax planning strategies that we use. Okay. So, one of the things is a lot of people, even with successful businesses, aren't necessarily running into the exemption. And so, income tax planning has become as important. I've always thought it's as important as a state tax planning personally because my deal is if I pay income taxes, I have less cash currently. And Hey, if I'm dead, I'm not sure I really care how much is left for my kid, to be honest. So, I personally am passionate about the income tax planning piece that is right in conjunction with estate planning. And what we've seen in recent years is states have hugely varying rates.

Speaker 2: (19:14)
And you look at California for example, which I think is 13.3%. And they were adding some type of excise taxes. I almost have trouble keeping up with all the California tax legislation. Then we have several states that have no income tax, or they have income tax depending on certain situations. And so if you're say a resident of a state like California, or a high income tax state, and even Nebraska, frankly, has a fairly high income tax rate, but we have a law in Nebraska that makes some of our strategies kind of difficult to do, which we won't get into that today. But one of the strategies is what's called an intention. We call it an, it will, it can be a, it's an ING, right? It's an intentional non-grantor trust. So, we talked about what a grantor trust is. What's a non-grantor trust?

Speaker 4: (20:05)
A non-grantor trust would be one where,   it is basically separate from me. So, when I set up the trust, a non-grantor trust would be one that pays its own tax. It pays its own income tax. ,, so if, if there's a hundred shares of Tesla in there and it kicks off a $50 dividend, I don't pay that tax as the grand tour of a non-grantor trust that trust pays the tax.

Speaker 2: (20:32)
So the strategy with the ING and the common ones we see are sings dings, and NINGs right. Ning is the Nevada intentionally non-grantor dress. And then if it's in South Dakota, we add an S to the Ang. If it's

Delaware, it's the dang. Those are the most common states. There are some other states that do those, but there's other states that have really kind of focused some of their trust laws to make this possible. Now we do see states and currently California being one of them is looking at some legislation to try and make this a more difficult strategy. What we've got to do when we do structure an ING is have a type of income. Essentially, what we're trying to do right, is we're trying to take California income and move it to Nevada. And Nevada has no state income tax. So a great state to live in.

Speaker 2: (21:18)
It's also got reasonably nice weather. I don't love Las Vegas, but there's other great places, right? And so, it's also got great trust laws, great asset protection laws. Delaware does. And our neighboring state South Dakota does. There are several other states. So, I'm not meaning to leave any of those out, but these are the ones we've done a lot of work within recent years. But let's say you're a California resident. You've got a, you own a business you're getting ready to sell it. You don't really, maybe you've used up all your state tax exemption or you don't really care. And all you're trying to do is stave some state income taxes. So, what you do is you create this non-grantor trust in Nevada, correct. Now, how do I keep California from taxi in that? Can I do it if, uh, what I'm putting in that trust is California real estate.

Speaker 4: (22:03)
No, because California real estate, it's going to get taxed

Speaker 2: (22:06)
In California because it's sourcing. So, you must be aware of the source income rules when you structure these. So, what if I set up, what if I have an S corporation that does business in California? Am I going to get that into the, am I going to get that taxed in Nevada? And it's probably not because it's probably still going to be sourced flow through and it's going to flow through to the residents. So that's a bigger question, right? The best-case scenario, right, is I have a C corporation and it has income from a variety of sources. And none of those sources are in California, not just California, I'm picking on California, because we have a lot of familiarity with that recently. But any of the high tax states that we're trying to remove income from to another state, the best asset is the C corporation, maybe with income that you're not going to have source income.

Speaker 2: (22:55)
So it's as much maybe as a consulting corporation, right? So, you might have the individual who's getting paid out of. There might have be taxed in the state there and providing services a whole other conversation we won't get into. But for this strategy, what we might do is say, take some C corporation stock. That's owned by somebody in California, and we create this non-grantor trust in Nevada. And then the corporation sells, and the trust pays. We still pay federal income tax. This is not a federal income tax reduction. But what we do is we've lost the state income tax. So, if you're California pan 13.3%, or the other states are Washington and Oregon, I think have high state income tax or any of those. And what you're doing is you're reducing that state income tax rate. What we're not doing is we're not doing anything for state tax purposes with this, right.

Speaker 4: (23:49)

Uh, that's correct. It's a, it's a, it's a non-grantor trust. But the transfer that you make is incomplete. So, for estate pit, for estate tax purposes, it's incomplete. So, for estate tax purposes, it's still included in your estate.

Speaker 2: (24:05)
And so what we do is we've kind of reversed the strategy, right? So now we're changing that soon. Hey, this is still going to be in your state. So, we're not going to reduce your state. We're just purely trying to avoid or reduce the state income taxes.

Speaker 4: (24:20)
We wanted to reduce income taxes, state income taxes. And that's, that's what the goal of this thing.

Speaker 2: (24:26)
And so how do we make sure that we maintain that non-grantor trust status?

Speaker 4: (24:32)
Well, you do have to be careful about what types of powers that, that you do have, and the distributions that you take out of it.

Speaker 2: (24:41)
So if I have my California residents and we formed this Ning, so we have that in Nevada, and then we just start distributing them cash.

Speaker 4: (24:55)
Well, the distributions of the cash

Speaker 2: (25:00)
Can create issues. They don't necessarily,

Speaker 4: (25:02)
It doesn't have to know, but it can

Speaker 2: (25:06)
Depends a little on the structure of the trust, right? What might be a bigger issue is if I take the proceeds of that. So, I put everything into the name in Nevada, sell it, avoid state income tax, but then I invest the proceeds back in California, real estate, right? And then I've created California source income sort of defeated. So, the thing with the Ning is there's a, there's a significant amount of issues that you must run through and whatever state income tax you're trying to avoid. I think one of the big mistakes that we see made, or how powers to a point are structured, how rice is structured, it's a whole art and science IRS. Isn't currently ruling on these trusts, but it is a common strategy and review in reducing state income taxes. And there's some other trusts types that we can use. Those are the three that we're going to cover today. And so, I want to thank you, Mike, for participating on this. We're going to talk also our third favorite topic is the charitable strategies, which is another thing that people consider as we get to the end of our episode. I want to thank our sponsors, interactive, legal, and Carson, private client.

That's all for now. Thanks for listening to this week's episode and stay tuned for our weekly releases,

Speaker 6: (26:24)
Hurrdat media production.