

Estate Planning Strategies & Tax Implications Ahead of Liquidity Events

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Pre-transaction estate planning strategies

- Transfer to irrevocable trust in exchange for a note (IDGT)
- Grantor retained annuity trust (GRAT)
- Qualified small business stock (QSBS) after OBBBA

Pre-transaction charitable planning

- Preliminary considerations
 - Charitable planning vehicles
 - Assignment of income doctrine
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PRE-TRANSACTION ESTATE PLANNING STRATEGIES

General Estate Planning Considerations

■ Valuation issues

- Discounts
- Proper disclosure on the gift tax return. Reg. 301.6501(c)-1(f).

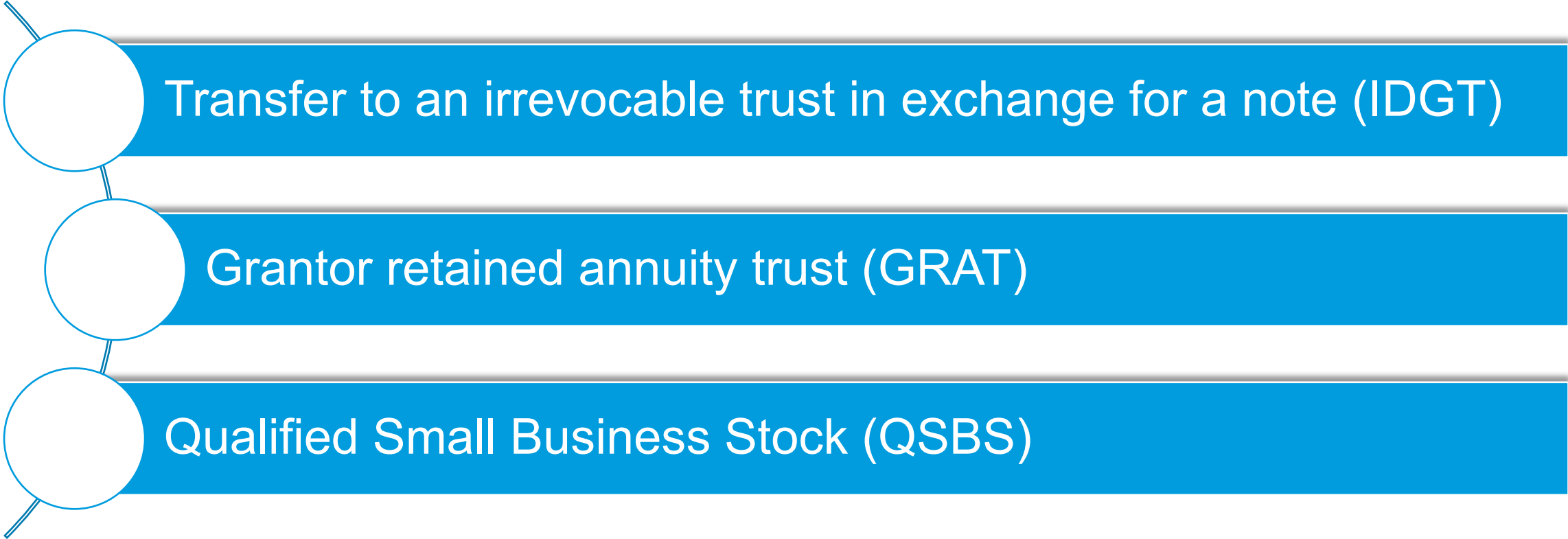
■ Cashflow analysis

- Is the business owner retaining enough income?

■ Starting early enough to appropriately handle all issues and tasks, such as:

- Appraisal process
- Implementation of appropriate estate planning and business succession documents
- Transactions that involve multiple steps

Common pre-transaction estate planning strategies

A diagram on the left side of the slide features three white circles arranged vertically, connected by thin lines. Each circle is positioned to the left of a blue horizontal bar that contains text. The top circle is connected to the top bar, the middle circle to the middle bar, and the bottom circle to the bottom bar. The bottom circle has a small line extending from its bottom-left edge.

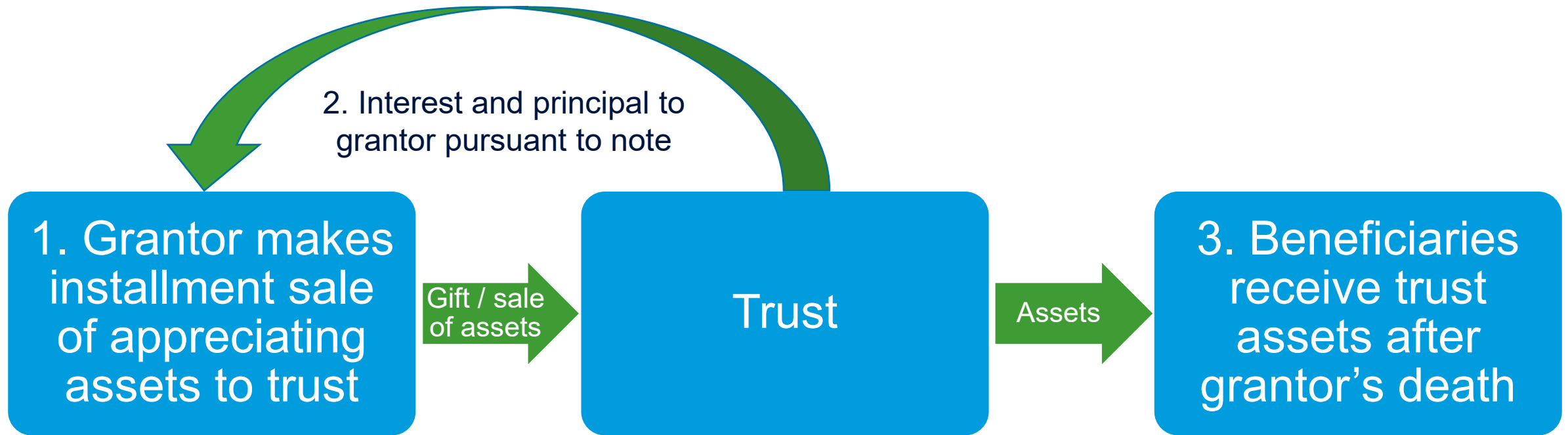
Transfer to an irrevocable trust in exchange for a note (IDGT)

Grantor retained annuity trust (GRAT)

Qualified Small Business Stock (QSBS)

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Transfer to an irrevocable trust in exchange for a note (IDGT)

Structure

Gift made to irrevocable trust (seed gift)

Business interest sold at discount to trust for promissory note

Interest at Applicable Federal Rate (AFR). Sec. 1274.

Trust assets then fund payments to grantor under note

Transfer to an irrevocable trust in exchange for a note (IDGT)

Income tax

- Grantor trust. Rev. Rul. 85-13.
- Death as realization event?

Gift tax

- Seed gift is the only taxable gift

Estate tax

- Note payments may be included in estate
- If grantor dies before note paid off, outstanding balance included in estate

GST tax

- Exemption may be allocated when trust established

Transfer to an irrevocable trust in exchange for a note (IDGT)

May be suitable for clients:

- Who have appreciating estate with significant estate tax exposure
- Who wish to transfer assets that have a depressed value and/or will qualify for significant valuation discounts
- When trust assets are expected to outperform AFR during note term
- When trust assets generate sufficient cashflow to satisfy note payments and enable client to pay income tax

Transfer to an irrevocable trust in exchange for a note (IDGT)

May be unsuitable for clients:

- When grantor trust status or cashflow needs may become too burdensome
- Who need to make seed gift and have insufficient gift/GST tax exemption
- When there is concern that trust assets may not outperform AFR
- When trust assets have very low basis and concerned about carryover basis for trust beneficiaries after client's death
- With limited life expectancy
- Who have insufficient time before liquidity event to properly implement the transaction

Grantor retained annuity trust (GRAT)

Grantor Retained Annuity Trust (GRAT)



Structure Discounted business interest transferred by gift to irrevocable trust

Annuity paid to grantor for term of years using Sec. 7520 rate

Annual payment often rolled into new GRAT

Grantor retained annuity trust (GRAT)



Income tax

- Grantor trust



Gift tax

- Transfer to trust is a taxable gift, but often “zeroed” out



Estate tax

- If grantor survives term, appreciation over Sec. 7520 rate outside grantor’s estate



GST Tax

- Exemption allocated upon end of term. Sec. 2642(f).

Grantor retained annuity trust (GRAT)

May be suitable for clients:

- Who have appreciating estate with significant estate tax exposure
- Who wish to transfer assets that have a depressed value and/or will qualify for significant valuation discounts
- Who wish to avoid using gift tax exemption or paying gift tax
- Where trust assets produce sufficient cashflow to pay annuity and allow client to pay income tax
- Who expect trust assets to appreciate beyond Sec. 7520 rate

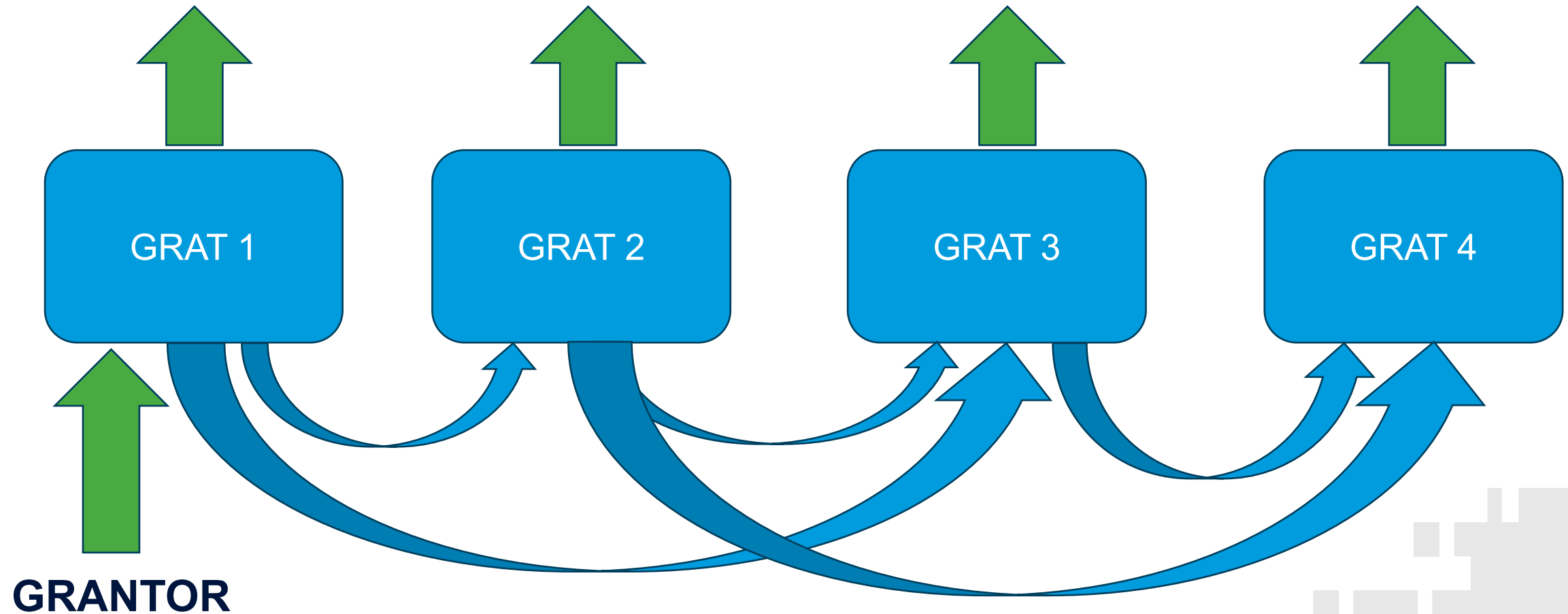
Grantor retained annuity trust (GRAT)

May be unsuitable for clients:

- Who wish to benefit grandchildren and use GST exemption
- When cashflow insufficient for paying annuity or cover income tax on trust assets
- When there is concern that the trust assets will have insufficient appreciation
- When trustee needs greater flexibility in making annuity payment to the client
- With limited life expectancy
- Who have insufficient time before liquidity event to properly implement the transaction

Two-Year Rolling GRATs

BENEFICIARIES



Example Illustration: GRAT and IDGT

	GRAT	IDGT
Discounted value of business interest	\$40 million	\$40 million
Rate	4.80%	4.83%
Term	5 years	9 years
Annual payment to grantor	\$9,115,000	\$1,738,800*
Assumed annual growth	5%	5%
Remainder left in trust at end of term	\$685,134	\$6,876,165
Taxable gift by grantor	\$0.00	\$4 million

*Balloon payment to the grantor in year 10: \$36,000,000

Recent IRS attack on GRATs

CCA

202152018
(12/30/2021)

GRAT funded with stock with a value based on a 409A appraisal

Grantor in merger negotiations when GRAT was funded

Six months later: tender offer to purchase stock at 3x the value used to fund GRAT

Grantor then funded charitable trust using tender offer value

IRS: Merger should have been considered in the GRAT valuation

IRS: GRAT not a qualified annuity under Sec. 2702

Qualified small business stock (QSBS) after OBBBA

Qualified small business stock (Sec. 1202): Fundamentals

- Excludes capital gains on sale of qualified small business stock (QSBS)
 - Inapplicable to sales of business assets
 - Subject to a value or basis cap
- Only applies to the sale of stock in a C corporation. Sec. 1202(c)&(d).
- C corporation must be qualified small business. Sec. 1202(d).
 - Excludes many professional service, farming, natural resources, and hospitality businesses. Sec. 1202(e)(3).
 - Must use 80% of assets in active conduct of qualified business. Sec. 1202(e).

Qualified small business stock (Sec. 1202): Fundamentals



- Generally, taxpayer must have received the stock directly from the corporation. Sec. 1202(c).
- Taxpayer must meet holding period requirement. Sec. 1202(a).
- Taxable gain from QSBS sale: may elect to rollover to other QSBS. Sec. 1045.

Qualified small business stock (Sec. 1202) after OBBBA

- OBBBA: changes effective for stock acquired after 7/4/2025
- Per issuer limitation on the gain exclusion. Sec. 1202(b).
 - Before OBBBA: Greater of either \$10 million or 10x basis
 - After OBBBA: Greater of either \$15 million (indexed for inflation) or 10x basis

Qualified small business stock (Sec. 1202) after OBBBA

- \$10 million limit for stock acquired on or before 7/4/2025. Sec. 1202(b).
 - Limit decreased by aggregate amount of gain from prior years
 - Limitation applies even if dispose of stock after 7/4/2025
- \$15 million limit for stock acquired after 7/4/2025. Sec. 1202(b).
 - \$15 million (indexed for inflation) reduced by prior gains (including gains before 7/4/2025)
- 10x basis exclusion: aggregate adjusted basis of QSBS issued by such corporation and disposed of during taxable year. Sec. 1202(b).
 - Additions to basis after original issuance ignored
 - Not reduced by sales in prior years

Qualified small business stock (Sec. 1202) after OBBBA

- **Exclusion holding periods. Sec. 1202(a).**
 - 50% exclusion for stock held for at least 3 years
 - 75% exclusion for stock held for at least 4 years
 - 100% exclusion for stock held for at least 5 years
- **Tax rate on non-excluded (taxed) gain:**
 - If subject to 50% or 75% exclusion - 28% capital gains rate. Sec. 1(h)(4)(A)(ii), (h)(7).
 - May also be subject to net investment income tax. Sec. 1411.
- **Maximum asset value for corporation. Sec. 1202(d).**
 - OBBBA: increased from \$50 million to \$75 million (indexed for inflation)
 - \$75 million cap only applies to stock issued after 7/4/2025
 - Asset value determined when corporation issues the stock

Qualified small business stock (Sec. 1202) after OBBBA

Multiplying the Per-Issuer Limitation. Sec. 1202(b)(1).

- Each transfer by gift may create a new limitation for the recipient. Sec. 1202(h).
- Recipient must be an eligible shareholder
- Gifts to non-grantor trusts could allow each trust to claim separate limitation
- Gift to non-grantor trust under which beneficiary is a partial owner: both the trust and the beneficiary may have separate limitation

Anti-abuse rules for multiple trusts under Sec. 643(f)

- Same grantors, same beneficiaries and principal purpose of tax avoidance

PRE-TRANSACTION CHARITABLE PLANNING

Preliminary considerations for charitable contributions of private business interests

Timing is critical

- Assignment of income doctrine

Limitations applicable to the charitable recipient

- Excess business holdings excise tax. Sec. 4943.
- Unrelated business income tax (UBIT). Sec. 511-516.
- Liquidity concerns

Legal requirements of the business entity and its owners

- Amendments to the shareholder agreement
- Changes to capital structure and business governance

Preliminary considerations for charitable contributions of private business interests

Income tax reporting for the donor

- Substantiation of gifts
- Appraisals
- Reg. 1.170A-16

Potential reduction in tax benefits to the donor

- AGI limits
- Ordinary income recognition
- Self-dealing excise tax. Sec. 4941.

Charitable planning vehicles

Charitable Remainder
Trust (CRT)

Charitable Lead Trust
(CLT)

Donor Advised Fund
(DAF)

Private Foundation (PF)

Avoid the assignment of income doctrine

The problem:

- Business owner seeks to transfer interest to charity to obtain charitable deduction and avoid capital gain on sale of the interest
- If the transfer to charity is completed shortly before the completion of the sale of the business interest, the business owner may be taxed on the sale proceeds for the interest transferred to charity
 - Business owner treated as receiving sale proceeds and transferring the sale proceeds to charity; business owner taxed on the charity's sale proceeds

Although there is some gray area, for the doctrine to apply, when the gift is made to the charity, the sale must be *practically certain to occur*, or the charity must be *legally obligated* to sell the interest.

Hoensheid v. Commissioner, T.C. Memo. 2023-34 (March 15, 2023)



Shareholder of S corp contributed stock to DAF before sale of business

Gift completed only 2 days before closing on business sale

Court determined that the business sale was virtually certain when DAF received the gift; applied the assignment of income doctrine

Taxpayer lost charitable deduction as well due to inadequate appraisal

Thank you

for your time and
attention

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