## Plan for the Estate and Gift Tax

***Business Owner Action Item:*** Engage Hibiscus Legal to (i) evaluate the estate and gift tax liability, and (ii) reduce the estate and gift tax liability.

***Why is This Important?*** The best opportunity to reduce or eliminate a business owner's estate and gift tax liability is prior to the sale.

***In My Experience:*** An estate and gift tax plan should be integrated with the revocable trust and the asset protection plan.

The estate tax is a tax on the right to transfer property at death. The gift tax is a tax on the right to transfer property during life. The *Estate and Gift Tax Exemption* is the amount of property that the business owner can transfer to others (usually children and grandchildren) without incurring estate or gift tax. The business owner can use the *Estate and Gift Tax Exemption* during life (to reduce or eliminate gift tax) or at death (to reduce or eliminate estate tax). The *2023 Estate and Gift Tax Exemption* is $12.92 million per person. A married couple has a combined *2023 Estate and Gift Tax Exemption* of $25.84 million.

**Step 1 – Calculate "Gross Estate"**

- The Gross Estate consists of the fair market value of everything the business owner owns or has an interest in at death.

**Step 2 – Calculate your "Taxable Estate"**

- Subtract the "Estate and Gift Tax Exemption" from your Gross Estate.
- Gross Estate - Estate and Gift Tax Exemption = Taxable Estate.

**Step 3 – Calculate your "Estate Tax Liability"**

- Multiply the Taxable Estate by the marginal estate tax rate.
- Taxable Estate * 40% = Estate Tax Liability

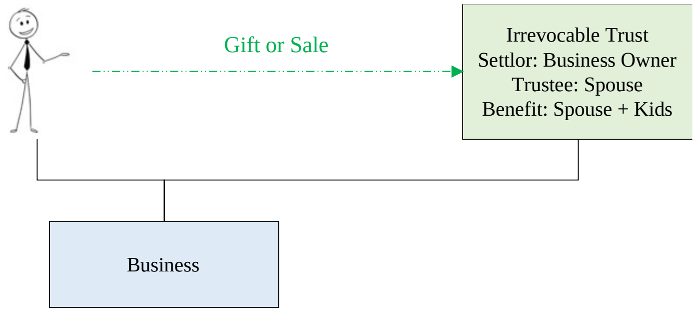
If the business owner's Taxable Estate = 0, then estate and gift tax planning is not needed.

If the business owner's Taxable Estate > 0, then we recommend the transaction described below to reduce or eliminate the Estate Tax Liability.

***Why is the Estate Tax Liability relevant?*** If the business owner were to die today, then his estate would be required to pay the Estate Tax Liability without any other planning.

## Transaction: Transfer Stock in the Company to an Irrevocable Trust

- The business owner should transfer stock in the Company to an irrevocable trust prior to the sale, which removes the stock from the business owner's Gross Estate.




- The purpose of transferring the stock prior to the sale is to engage in *valuation arbitrage*. *Valuation arbitrage* uses the least amount of the Estate and Gift Tax Exemption required to eliminate the estate and gift.
- The Estate and Gift Tax Exemption is the amount of property that the business owner can transfer without incurring estate or gift tax.
- Prior to the sale, the value of the stock for estate and gift tax purposes is established by a qualified appraisal. The appraisal is allowed to discount the value of the stock by applying *valuation discounts*. *Valuation discounts* can range from 15% to 40%.
- For purposes of simplicity, assume that a 50% valuation discount is applicable to the stock transferred. Under these assumptions each gift of $1 of stock represents $2 of underlying stock value. In other words, the business owner is able to transfer $2 out of his Gross Estate by using $1 of his Estate and Gift Tax Exemption.
- ***Example 1***
  - In 2023 a qualified appraisal values the Company at $15 million before applying a 25% valuation discount. After applying the 25% valuation discount a qualified appraisal values the Company at $11.25 million.
    - ($15M * (1-.25) = $11.25M)
  - The business owner can gift 100% of the stock in the Company to an irrevocable trust by using $11.25 million of his $12.92 million Estate and Gift Tax Exemption to eliminate the gift tax.
  - Assume that the Company is sold to an unrelated party in 2025 for $20 million. The business owner effectively removed $20 million from his Gross Estate by using $11.25 million of his Estate and Gift Tax Exemption.
  - The business owner avoided $3.5 million Estate Tax Liability.
    - (($20M - $11.25M) * 40% = $3.5M)

***In My Experience:*** The valuation of the Company prior to the sale is usually significantly less than the price the Company is sold to the Buyer due to (i) the appreciation of the stock (either through organic growth of the Company or improving operations as a result of the quality of earnings report) and (ii) valuation discounts.

***In My Experience:*** Transferring stock in the Company to an irrevocable trust integrates asset protection planning because an irrevocable trust has strong asset protection qualities.