

# Katten

PRESENTATION TO LOYOLA FAMILY BUSINESS CENTER

## **Estate Planning Hot Topics for 2023**

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# Today's Agenda

- I. COVID and Aging “G-1s” – the importance of core planning
- II. Wealth transfer opportunities in the current economic and political environment
- III. Tax domicile planning
- IV. Corporate Transparency Act coming in 2024



## I. The Importance of Core Planning

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# Estate Plan Overview

- “Core” Estate Planning Documents – Everyone Needs the Basics:

- Wills

- Public document
- Assets “pour over” to Revocable Trust
- Names “Executors” for estate
- Names “Guardians” for minor children

- Revocable Trust

- Private document
- Allows for probate avoidance *if funded during lifetime*
- Dictate succession of control of assets by naming a “Trustee”
- Dictates how assets distributed upon death (often in further trust)

# Estate Plan Overview

- “Core” Estate Planning Documents – Everyone Needs the Basics:
  - Power of Attorney for Property
    - Grant an “Agent” power to handle finances if you are unable to do so
    - Powers typically include power to pay bills, file tax returns, deal with brokerage and financial account, etc.
    - If no property power is executed and you become incapacitated, then guardianship required
  - Power of Attorney for Health Care
    - Grant an “Agent” power to handle health care decisions if you are unable to do so
    - Typically a broad grant of health care powers – including the power to “pull the plug”
    - Can cover organ donation and disposition of remains
    - If no health care power is executed and you become incapacitated, then guardianship required

# Estate Plan Overview

- Other considerations:
  - Asset Titling
    - Real Estate
    - Liquid assets (cash / securities)
    - Family business interests
    - Life Insurance / Retirement accounts
    - Tangible personal property
  - Asset protection planning
  - Planning for divorce (ex: prenuptial agreements; trusts)
  - Consider multiple powers of attorneys forms if spending substantial time in multiple states

# Hypothetical – Importance of Asset Titling

- Clients are a married couple living in Illinois.
- Clients executed “core” estate plan documents but did not transfer assets to Revocable Trusts during lifetime.
- Clients have all of their assets either (i) titled in joint tenancy, or (ii) payable on death by beneficiary designation to the surviving spouse.
- Upon the first spouse’s death none (\$0) of the predeceased spouse’s \$4 million estate tax exemption is used.
- This titling error costs the family approx. \$400,000 + growth.

# Family Business Concepts and Documents – Pillars to Consider

- Types of business entities
- Books and records (“minute book”)
- Controlling Documents
- Types of Equity Interests – e.g., Voting and Non-Voting Shares
- Transfers of Equity
  - Scenarios: gift, sale, divorce, bankruptcy, death
- Transfer Restrictions and Permitted Transferees
- S Corporation Issues



# Family Business Concepts and Documents – Books and Records

- Organizational Documents
  - Charter / formation
  - Operating Agreement, By-Laws, Shareholders Agreement
- Stock certificates
- Annual reports
- Annual written consents
  - *Respect the corporate formalities → if the business owner does not, then neither will the courts, creditors, or the IRS.*

# Family Business Concepts and Documents – Controlling Documents

- Need to understand key provisions of operable documents.
- Important provisions:
  - Manager / Board of Directors and succession
  - Voting provisions – simple majority or supermajority
  - Distribution provisions
    - Income tax
    - Additional
  - Transfer restrictions and buy-sell provisions
- Has garnered more attention in the estate planning world due to recent litigation

# Family Business Concepts and Documents – Transfer Restrictions and Permitted Transferees

- Need to review transfer restrictions in controlling documents
- Who you can or can't transfer to
- Invalid transfers could trigger buy-sell provisions
- Transfers to “Permitted Transferees” are typically authorized – e.g., descendants, other shareholders, qualified trusts for spouses

## **II. Wealth Transfer Opportunities**

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# Timing is Everything

- Now is a golden opportunity for business owners to engage in succession and estate planning.
  - Lower business valuations
  - All-time high transfer tax exemption amounts
  - Moderate interest rates (AFRs)
  - Powerful intergenerational wealth transfer tools
  - Political winds blowing towards higher tax rates



# Estate Tax Overview

- Estate (death) taxes are a looming issue for the owner(s) of a successful family business.
- Federal estate tax exemption: \$12.92 million per person\* in 2023.
  - Thus, no federal estate tax due for a married couple until combined assets are over \$25.84 M.
  - Federal estate tax rate: 40%.
  - \*Temporarily doubled through 2025. Reverts to \$5 million + inflation adjustment in 2026.
- States with a separate state estate tax: IL, CT, D.C., HI, ME, MD, MA, MN, NY, OR, RI, VT, and WA.
  - Illinois = \$4,000,000 estate tax exemption
- The federal estate tax has two “sister” taxes, meant to prevent simple avoidance of the estate tax: the gift tax and the generation-skipping transfer (“GST”) tax.
- There are many strategies to reduce impact of the estate tax (and gift/GST taxes) on the wealth of family business owners.

# Example: Business Owners, John and Jane, Planning to Sell Growing Company 3 Years from Today (married IL residents)

2023 Assets		Hypothetical Sale of the Company in 2026	
\$ 50,000,000 <sup>1</sup>	Value of Family Company (the "Company")	\$150,000,000 <sup>3</sup>	Value of the Company
\$ 10,000,000	Other Assets	\$ 10,000,000	Other Assets
-\$ 25,840,000	Combined Federal Estate Tax Exemption	-\$ 25,840,000	Combined Federal Estate Tax Exemption
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\$ 34,160,000	Net Taxable Estate	\$134,160,000	Net Taxable Estate
<b>\$ 17,080,000</b>	<b>Estimated Federal and Illinois Estate Taxes at the death of the survivor of John and Jane<sup>2</sup></b>	<b>\$ 67,080,000</b>	<b>Estimated Federal and Illinois Estate Taxes at the death of the survivor of John and Jane<sup>2</sup></b>

## Notes

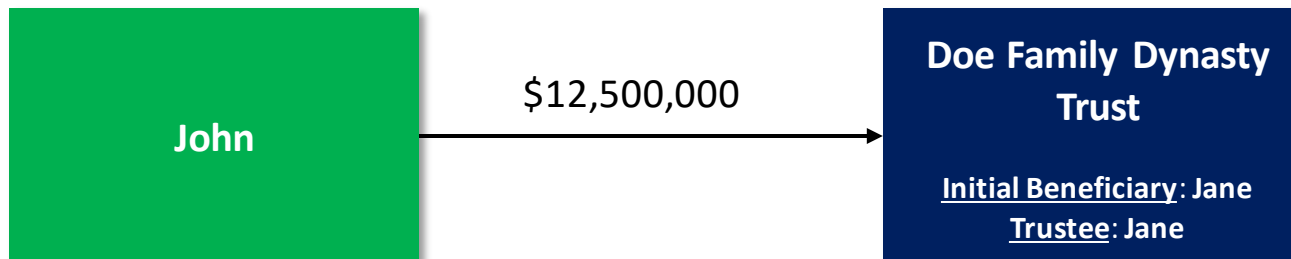
1. Based on a hypothetical \$75,000,000 liquidation valuation of the company, but valued on a minority basis applying discounts for lack of marketability and control.
2. The applicable federal estate tax exemption amount in 2023 is \$12,920,000 per person and the Illinois estate tax exemption amount is \$4,000,000 per person. The federal estate tax rate is 40% and the Illinois estate tax rate is approximately 10% (resulting in an approximate blended rate of 50%). For business owners in states without a state estate tax the tax rate is the 40% federal rate.
3. Based on a full liquidation value upon sale to a third-party purchaser.

# Planning Tool: John Makes 2023 Gift to Doe Family Dynasty Trust

**Step One:** John creates the “Doe Family Dynasty Trust”.<sup>1</sup>



**Step Two:** John gifts \$12,500,000<sup>2</sup> of value in the Company to the Dynasty Trust.

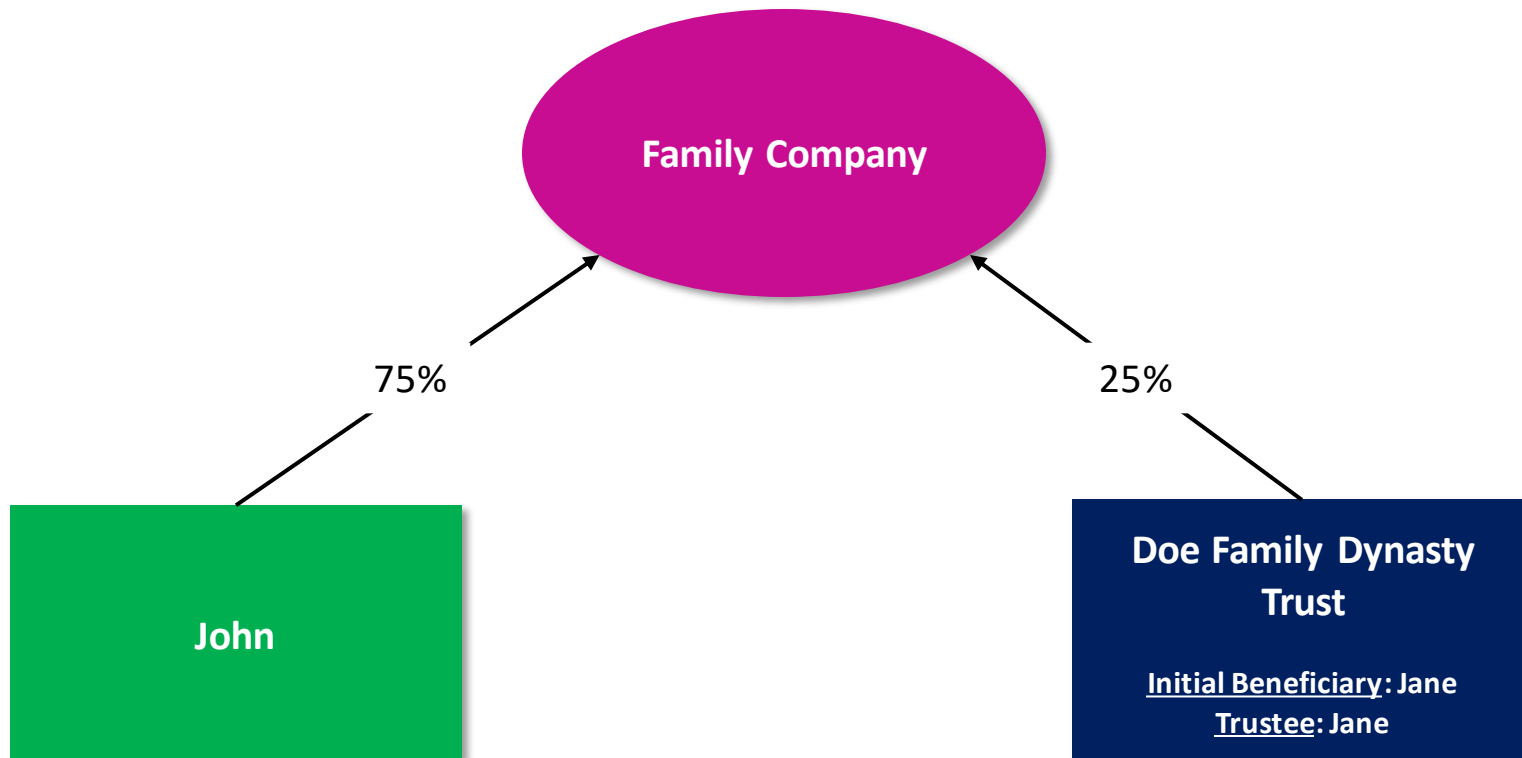


## **Notes**

1. Jane will be the initial sole beneficiary; distributions may be made for Jane's health, education, maintenance and support and her best interests (if an Independent Trustee is added). Jane will have a power over the trust to support John and Jane's children, if any, from the trust assets. The Trust will be GST exempt.
2. The \$12,500,000 gift will use John's gift and GST exemptions and represents a 25% interest in the Company. The gift will be reported on John's 2023 gift tax return.



# Summary of Resulting Ownership of the Company in 2023



**Future distributions from the Company will be distributed 75/25 to John and the Dynasty Trust<sup>1</sup>, respectively.**

## **Notes**

1. The Dynasty Trust will be a grantor trust as to John. This means that so long as John is willing to, he will pay the income taxes on behalf of the trust. This "grantor trust" feature of the trust offers the family a powerful additional way to transfer wealth to the next generation as it allows John to pay the income tax for his beneficiaries while living (without such tax payments being considered a gift).

# “Fast Forward to 2026”

- The Company sells to a third party for \$150,000,000, resulting in the following distribution waterfall:
  - John receives 75% of the proceeds (\$112,500,000).
  - The Dynasty Trust receives 25% of the proceeds (\$37,500,000).
  - John pays estimated income tax of \$45,000,000 on the entire amount (\$150M x 30%), leaving John with \$67,500,000 of liquidity post-sale.
  - The Dynasty Trust pays \$0 in income tax and has \$37,500,000 in assets.
- **In summary**: John used \$12,500,000 of his gift/estate tax exemption in 2023 to transfer \$37,500,000 out of his taxable estate, saving his family approximately \$12,500,000 in estate taxes (i.e. John removed \$25,000,000 of appreciation from John's estate x 50% estate tax rate).
  - Assets owned by the Dynasty Trust will continue to grow tax free of estate tax.
  - Thus, if the \$37,500,000 in the Dynasty Trust doubled to \$75,000,000 in John's lifetime, this planning would save his family an additional estimated \$18,750,000 of estate taxes on the appreciation of the trust's assets.

# Optional Additional Pre-Transaction Planning

## I. Gifts by Jane

- Jane could do similar planning to use up her gift/estate tax exemption<sup>1</sup>, essentially doubling the potential tax savings.

## II. Intra-Family Sale of Company shares (prior to assumed sale to a third party in 2026)

- Even if John has exhausted his own gift/estate tax exemption, John could sell additional interests in the Company to the Dynasty Trust<sup>2</sup> to further maximize the benefit of pre-transaction wealth transfer planning.
- For example, John could sell another 25% of the Company to the Dynasty Trust (in exchange for a Promissory Note in the amount of \$12,500,000), such that the resulting ownership of the Company would be 50% held by John and 50% held by the Dynasty Trust.
- A side-by-side comparison of how such a sale would change the previous “Fast Forward to 2026” illustration is included on the next slide.

### Notes

1. We would not recommend John being an initial beneficiary of Jane’s irrevocable trust; typically John and Jane’s children would be the initial beneficiaries.
2. The sale to the Dynasty Trust would likely be in exchange for a Promissory Note. The term of such a Note would likely be 9 years, and use the applicable federal mid-term interest rate in the month of the sale (for example: in April 2023, the mid-term AFR is 4.15%).

# Fast Forward to 2026: John's Gift and Sale Version

- The Company sells for \$150,000,000 (**same**), resulting in the following distribution waterfall:
  - John receives: ~~75%~~ **50%** of the proceeds (~~\$112,500,000~~ **\$75,000,000**).
  - The Dynasty Trust receives: ~~25%~~ **50%** of the proceeds (~~\$37,500,000~~ **\$75,000,000**).
  - John pays estimated income tax of: \$45,000,000 on the entire amount (\$150M x 30%) (**same**)
  - Leaving John with liquidity post-sale of: ~~\$67,500,000~~ **\$30,000,000**.
  - The Dynasty Trust pays: \$0 in income tax (**same**).
  - The Dynasty Trust has assets of: ~~\$37,500,000~~ **\$75,000,000** (and owes John \$12,500,000).
  - The Dynasty Trust could repay the Note: Resulting assets of John - **\$42,500,000**.
- **In summary:** John used \$12,500,000 of his gift/estate tax exemption in 2023 **and sold another 25%** of the Company to transfer ~~\$37,500,000~~ **\$75,000,000** out of his taxable estate, saving his family Approximately ~~\$12,500,000~~ **\$25,000,000** in estate taxes.
  - Assets owned by the Dynasty Trust will continue to grow tax free of estate tax (**same**).
  - Thus, if the ~~\$37,500,000~~ **\$75,000,000** in the Dynasty Trust doubled to ~~\$75,000,000~~ **\$150,000,000** in John's lifetime, this planning would save his family an additional estimated ~~\$18,750,000~~ **\$37,500,000** of estate taxes on the appreciation of the trust's assets.

## **III. Tax Domicile Planning**

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# Key Considerations in Changing Domicile

## —Financial-based:

- Income Taxes
- Estate Taxes
- Asset Protection
- Trust administrative laws
- New employment opportunities
- Standard of living

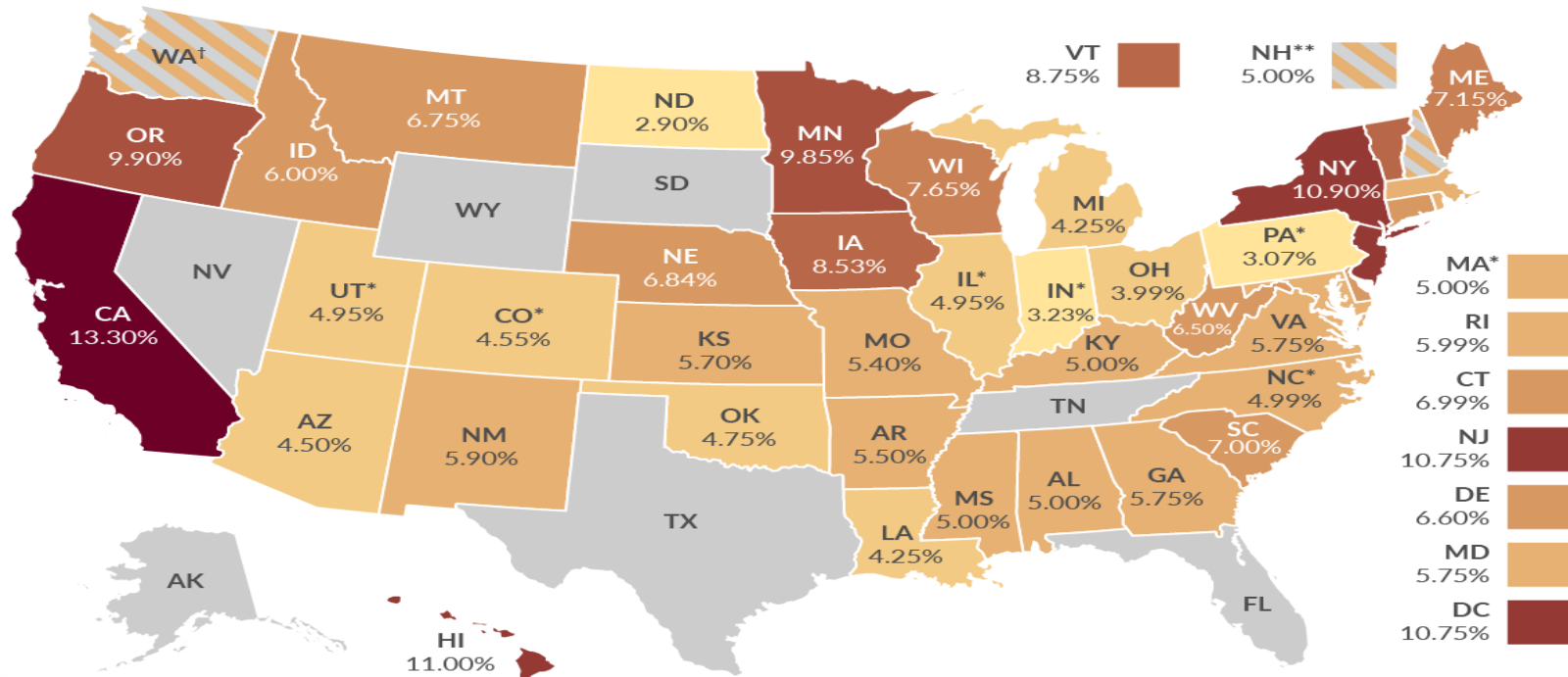
## —Non-Financial-based:

- Geography vis-à-vis friends and family
  - Access to health care
  - Weather/climate
- Advanced planning regarding changing *asset* domicile
  - Income tax planning considerations: residency, different entity taxation, audits

# State Income Tax Overview

## How High Are Individual Income Tax Rates in Your State?

Top Marginal State Individual Income Tax Rates (as of January 1, 2022)



Note: Map shows top marginal rates: the maximum statutory rate in each state. This map does not show effective marginal tax rates, which would include the effects of phase-outs of various tax preferences. Local income taxes are not included. Missouri's top marginal rate will be reduced to 5.3% if certain revenue triggers are met.

(\*) State has a flat income tax.

(\*\*) State only taxes interest and dividends income.

(†) State only taxes capital gains income.

Sources: Tax Foundation; state tax statutes, forms, and instructions; Bloomberg Tax.

Top State Marginal Individual Income Tax Rates



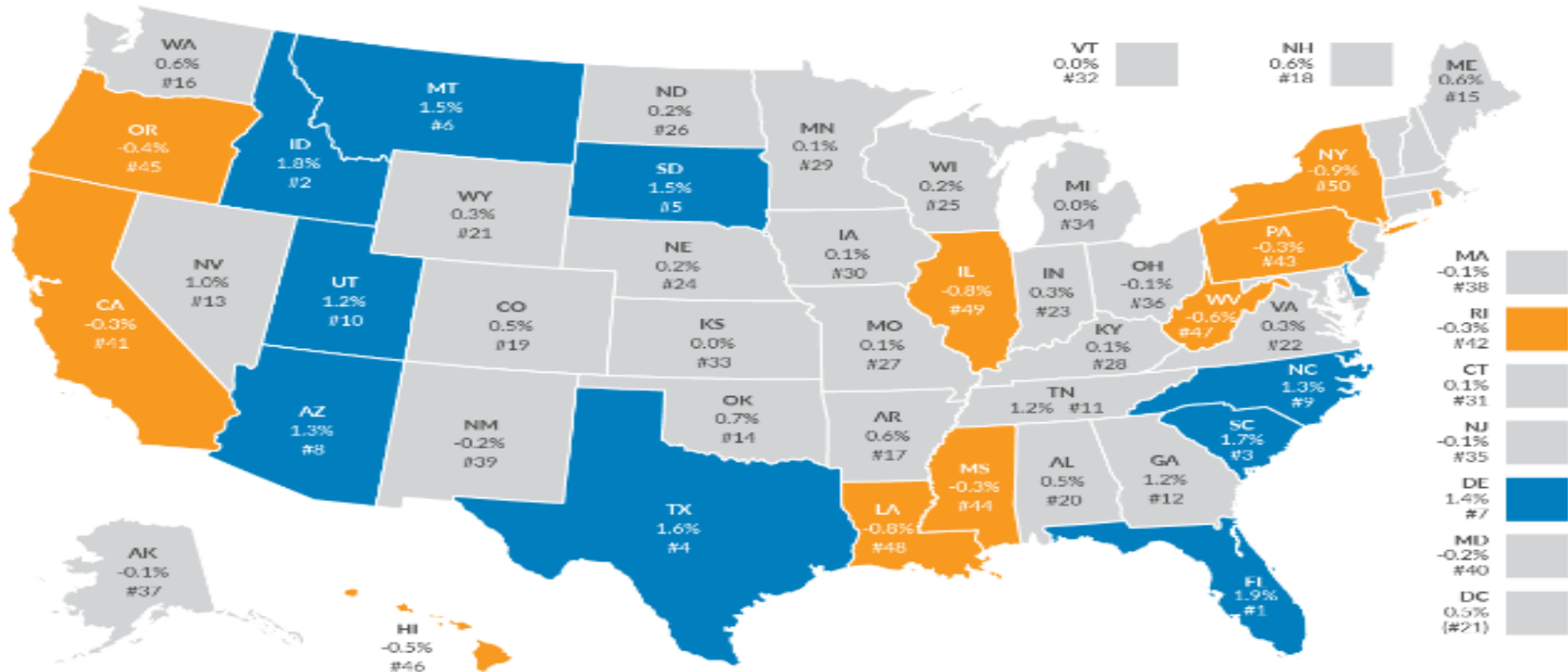




# State Population Change Overview

## State Population Change in 2022

State Migration Patterns, from Most Inbound to Most Outbound, 2022



Note: D.C.'s rank does not affect states' ranks, but the figure in parentheses indicates where it would have ranked if included.  
 Source: U.S. Census Bureau.

- Top 10 States for Inbound Migration
- Top 10 States for Outbound Migration

# Change in Domicile – Income Tax Considerations

- **Residency** = “where one resides”; put simply, where you are located
- **“Domicile”**
  - The place where a person has fixed his or her habitation and has a permanent residence without any present intention of permanently removing therefrom.
  - The place to which a person has voluntarily fixed the habitation of himself/herself and family, not for a mere special or limited purpose, but with the present intention of making a permanent home, until some unexpected event shall occur to induce him/her to adopt some other permanent home.
  - Once established, a person’s domicile continues until a new domicile is effectively established
- A person can have multiple residences, but **only one domicile**.

## LEGAL SWAMP MAKES FLORIDA A PERFECT HOME FOR O.J.

By Mike Royko  
Chicago Tribune • Mar 04, 1997 at 12:00 am

# Change in Domicile – Income Tax Considerations

- State Residency in M&A Planning
  - Sale of a corporate security is considered non-business income and is sourced to the taxpayer's state of domicile
    - California has special rules for securities pledged as collateral for a loan
    - Theoretically, a taxpayer could change domicile immediately prior to a business sale but timing matters
  - Sale of a partnership interest is non-business income and is sourced to the taxpayer's state of domicile
    - Be mindful of hot assets
    - Recent California ruling required apportionment of hot asset income
  - An asset sale is apportioned to the states in which the taxpayer (partnership or corporation) conducts business
    - Domicile does not matter if business is conducted in high tax states

# Change in Domicile Planning – How?

- Domicile is based on intent – must prove an intention to move residence to new state.
  - **Case Studies**: Moving elderly parent to caregiver’s location
  - Must physically leave old jurisdiction
- Spend 6 months and a day in new state to acquire new domicile
  - In future years, be sure not to spend more than 6 months in any other jurisdiction --- but rules may differ by state
- Acquire personal residence in new state; sell residence in former state (best practice).
- Do not claim homestead exemption in former state
  - Only one bite at the tax apple
- File a declaration of domicile in new state (if applicable)

# Change in Domicile Planning – How?

- Burden of proof to establish domicile/non-domicile is on the taxpayer. Evidence to establish domicile or non-domicile includes:
  - Location of spouse and dependents
    - Spouses with split-residency does happen, though greater record-keeping is recommended
  - Voter registration, automobile registration and driver's license
  - Where one files Federal and state income tax returns
  - Home ownership or rental agreements
  - The temporary or permanent nature of work assignments in a state
  - Location of professional licenses, medical/healthcare providers, attorneys, accountants, etc.
    - A common consideration among our relocating clients
  - Location of clubs and/or organizational memberships and participation
  - Telephone and/or other utility usage over a duration of time

# Change in Domicile Planning – How?

- Burden of proof to establish domicile/non-domicile is on the taxpayer. Evidence to establish domicile or non-domicile includes:
  - **\*Revise estate planning documents\***
    - New state would likely still acknowledge and enforce prior documents (though powers of attorney are not always certain), but it is less desirable to rely on the prior jurisdiction's laws
  - Move banking to new state
  - Receive mail in new state
  - Move safety deposit box to new state
  - Subscribe to local newspaper
  - Relocate burial plots
  - Start filing Nonresident Returns to put outgoing jurisdiction on notice
- **Key point**: Record-keeping is critical --- keep a journal, keep receipts, etc.

# Change in Domicile – Trust Planning

- A Trust has one trust “situs” – the equivalent of domicile. Key factors:
  - Terms of the trust instrument
    - **Practice Tip**: Specify a trust situs – do not rely on a floating “where the trust is being administered”
  - Domicile of Grantor
  - Location of Trustee
  - Location of assets
- If situs is being changed, do it formally – helps support income tax position and avoids potential disputes
  - Common nonjudicial settlement objective
  - Decanting
  - Unilateral Trustee Power (via trust instrument or some state laws)

## **IV. Corporate Transparency Act**

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# The Corporate Transparency Act

- USA viewed as a tax haven? Yes → ability to create entities and not say who owns them.
- The Corporate Transparency Act creates a central registry of beneficial owners of entities.
  - Passed 1/1/21 as part of National Defense Authorization Act. President Trump vetoed it; Congress overrode the veto.
- Reporting Company: any entity created by filing with a Secretary of State.
  - Most trusts, general partnerships, and sole proprietorships do not qualify, but law may be expanded to include them in the future.
- Key dates:
  - Entity created on or after 1/1/24: 30 days to file.
  - Entity created before 1/1/24: initial filing due 12/31/24.

# The Corporate Transparency Act

- **\*\* Need to report to FINCEN the “Beneficial Owners” of each Reporting Company \*\***
  - Whoever **owns** (25%+) or **exercises substantial control** over a legal entity – ALL the way up the chain. More than 1 person may qualify. Likely includes all c-suite officers (due to control). Lenders who control collateral via pledge agreements?
  - Legal Name, birthdate, picture (i.e. driver’s license/passport), **residential address** (no P.O. box)
- Must keep all information current – 30 days to report change in beneficial owner information (i.e. new BOs, legal name change, address change, etc. Picture change?)
- \$500 **per day** civil noncompliance penalty; criminal penalties of \$10,000 and/or up to 2 years in prison (90 day safe harbor to correct errors).
- FinCEN ID numbers available to avoid disclosing information to anyone other than FinCEN and save updates to multiple Reporting Companies.

# The Corporate Transparency Act

- **\*\* “Company Applicants” also need to file with FinCEN – the people who file or direct the filing of the entity documents with the SOS.\*\***
- Goal is (i) to help law enforcement identify entities and mitigate money laundering, terrorism funding, and tax evasion, and (ii) support business transactions since it is easier to transact if parties know who is on the other side.
  - Database will NOT be public – just available to FinCEN and taxing authorities (compare with UK (yes); EU (no)).
- The remainder of 2023: we all need to
  - (i) educate ourselves on these rules;
  - (ii) consider shutting down entities that have little purpose or value;
  - (iii) determine company internal procedures to manage the filing requirements and timing; and
  - (iv) **GET A FinCEN ID NUMBER** – to protect your data, and for ease of updates.

# Questions??



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