Morgan Stanley

PRIVATE WEALTH MANAGEMENT

Insights for Entrepreneurs

Part Three: Overview of Wealth Planning Structures

Working as part of an integrated advisory team, your Morgan Stanley Private Wealth Advisor can help you make well-informed personal wealth management decisions at every stage of your company's development. Our goal is to provide you with the information, insight and resources that may help you reach your personal and professional goals. We are here to help you answer the key questions that arise at the intersection of your business strategy and your personal wealth management.

How Can I Use Trusts to Reduce My Long-Term Tax Exposure?

As the value of your company increases, it can become increasingly difficult to effectively redistribute the wealth among family members. One solution to this dilemma involves establishing estate planning structures that permit beneficiaries to profit from the appreciation in company value while hopefully minimizing the impact of federal estate and gift taxes.

Two planning structures that could be used in this regard are Grantor-retained Annuity Trusts (GRATs) and Intentionally Defective Grantor Trusts (IDGTs). Though not a trust, Family Limited Partnerships (FLPs) could also be used to transfer wealth generationally with less federal estate and gift tax impact. In each case, the basic methodology is to gift ownership interests to beneficiaries while valuations are as low as possible. By removing the assets from your federal estate, assets from your federal taxable estate prior to your death and subject to certain conditions and terms, those assets may be allowed to grow without federal gift and estate impact for your beneficiaries. This can be useful if you have already exhausted your approximately $12.92 million in 2023 lifetime estate and gift tax exemption (or roughly $25.84 million for married couples) or if you wish to preserve it for other wealth transfer opportunities.

It is important to note that to maximize potential federal estate and gift savings, your tax advisor may suggest you coordinate the implementation of your estate planning strategy with any sale or transfer of your business.

How Does a GRAT Work?

As the grantor, you create an irrevocable trust that pays you an annuity calculated based on the IRS Section 7520 proscribed monthly rate and the fair market value of the assets funding your GRAT, either a series of equal amounts or amounts that increase up to 20% per year. Trust assets remaining after at the conclusion of the fixed annuity period will pass to the beneficiary(ies) you named in the trust such as family members to whom you wish to transfer wealth. That amount designated for the trust beneficiaries is considered a gift for federal gift tax purpose. The value of the taxable gift is the fair market value of the assets transferred into the trust, minus the value of the annuity you "retained" as the grantor. The transfer to the trust can be structured so the value of the grantor's retained annuity interest is virtually equal to the market value of the property placed in trust. That results in a very small taxable gift on the creation of the GRAT ("zeroing out" the GRAT), which will be reported on the grantor's annual gift tax return.

Your GRAT can produce federal estate and gift tax savings if the trust property produces an annual return in excess of the IRS 7520 discount rate over the term of the annuity. The grantor could effectively shifts the entire value of that excess to the beneficiaries without making an additional taxable gift. The

grantor will also have separately paid any income tax liability of the trust, further leveraging this gifting technique. And if the GRAT is structured so the annuity "grows" by up to 20% per year, more principal could compound for the benefit of the remainder beneficiaries potentially allowing more property to pass to them at the expiration of the trust term.

How Does an Intentionally Defective Grantor Trust (IDGT) Work?

An IDGT is an estate planning tool that can be used by those who are attempting to freeze the value of an asset for estate planning purposes, assets like shares of your early-stage or pre-IPO company, for example.

The first step is to create the irrevocable trust, the IDGT. As the grantor, you then can sell assets to the IDGT in exchange for the trust's interest-bearing promissory note. The sale of the asset to the IDGT removes the asset from your federal estate. The interest rate will be based on IRS published rates and is often less than the rate used in GRATs. The note may provide for level payments of principal and interest, be self-amortizing or bear interest only with a balloon payment of principal. No gain or loss is recognized on your sale to the trust, and the repayment of the promissory note has no federal income tax consequences to you or the trust because you are treated as the owner of the trust for federal income tax purposes. By paying taxes on trust income, you, in effect, make additional transfers to the beneficiaries of the trust, that are not subject to federal gift tax.

Some practitioners suggest that a "seed gift" of at least 10% of the principal amount of the promissory note should be contributed to the IDGT, but you should consult with your own tax advisor. It's also important to note that there is a mandated watiing period between the seed gift and the sale to the trust. Such seed gift may not incur federal gift tax if the grantor has sufficient federal gift tax exemption remaining or if the gift qualifies for the federal gift tax annual exclusion. The IDGT can be effective for gifts to grandchildren and other remote descendants if the generation-skipping transfer (GST) tax exemption is properly allocated to the trust.

What Is a Family Limited Partnership?

A Family Limited Partnership (FLP) is an entity that enables you to gift limited partnership (LP) interests to family members or to a trust while retaining a General Partnership (GP) interest for yourself. As GPs, you maintain management and investment control over the partnership's underlying assets. The meaningful restrictions imposed upon limited partners as well as their lack of control over the broader FLP structure can provide substantial valuation discounts. This may minimize the impact of federal gift and estate taxes that your family might otherwise incur. (As recent court cases may have imposed additional risks on FLP's, be sure to consult your attorney.)

THE INSIGHTS FOR ENTREPRENEURS SERIES COVERS THE FOLLOWING ADDITIONAL TOPICS:

- Choosing a Business Structure
- Early-Stage Trust and Estate Planning
- The Public Sale of Privately Held Businesses
- Family-Owned Business Succession Strategies
- Philanthropic Strategies and Structures
- Understanding Equity Compensation

FOR FURTHER INFORMATION

If you wish to discuss which estate planning strategies and structures are best-suited to your personal and business goals, please speak to your Private Wealth Advisor. He or she can schedule a meeting with a Morgan Stanley Tax, Trust and Estate Specialist.

Morgan Stanley Smith Barney LLC does not accept appointments nor will it act as a trustee but it will provide access to trust services through an appropriate third-party corporate trustee.

This material has been prepared for informational purposes only and is subject to change at any time without further notice. Information contained herein is based on data from multiple sources, and Morgan Stanley Smith Barney LLC ("Morgan Stanley") makes no representation as to the accuracy or completeness of data from sources outside of Morgan Stanley Smith Barney LLC. It does not provide individually tailored investment advice. Be aware that the particular legal, accounting and tax restrictions, margin requirements, commissions and transaction costs applicable to any given client may affect the consequences described, and these analyses will not be appropriate to discuss with every client. The appropriateness of a particular investment or strategy will depend on an investor's individual circumstances and objectives.

Tax laws are complex and subject to change. This information is based on current federal tax laws in effect at the time this was written. Morgan Stanley Smith Barney LLC, its affiliates, Financial Advisors or Private Wealth Advisors do not provide tax or legal advice. Clients should consult their tax advisor for matters involving taxation and tax planning, and their attorney for matters involving trust and estate planning and other legal matters.

© 2023 Morgan Stanley Private Wealth Management, a division of Morgan Stanley Smith Barney, LLC. Member SIPC.

CRC 5810558 08/23 PWM264769 CS 743443-3525874 08/23