LENOX ADVISORS, INC

WEALTH MANAGEMENT
A D V I S O R

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Tax-smart strategies for leaving generation-ranging wealth

The generation-skipping transfer (GST) tax was designed to ensure that wealth is taxed at each generational level, and it's one of the most complex taxes in the tax code. So if you hope to leave wealth to grandchildren — even great-grandchildren and beyond — it's critical to consult with experienced estate planning advisors. But you also should understand some basics about how the GST tax works.

SKIP PERSONS AND OTHER RULES

To ensure that wealth is taxed at each generational level, the GST tax applies at a flat, 40% rate — in addition to otherwise applicable gift and estate taxes — to transfers that skip a generation. The tax applies to transfers to "skip persons," including your grandchildren, other relatives who are more than one generation below you and unrelated people who are more than 37½ years younger than you. But there's an exception for a grandchild whose parent (your child) predeceases you. In that case, the grandchild moves up a generation and is no longer considered a skip person.

Three types of transfers may trigger GST tax:

- "Direct skips," which are transfers directly to a skip person that are subject to federal gift and estate tax,
- Taxable distributions, or distributions from a trust to a skip person, and
- Taxable terminations.

In this last case, if you establish a trust for your children, a taxable termination occurs when the last child beneficiary dies and the trust assets pass to your grandchildren.

EXEMPTIONS AND ALLOCATIONS

The GST tax doesn't apply to transfers to which you allocate your GST tax exemption (up to $13.61 million for 2024). In addition, the GST tax annual exclusion allows you to transfer up to $18,000 in 2024 to any number of skip persons without triggering GST tax or using up any of your GST tax exemption. However, the GST tax exemption must be allocated to a transfer to shelter it from tax.

Ordinarily, to allocate GST tax exemptions, you must affirmatively elect to do so on a timely filed gift tax return. Transfers to a trust qualify for the annual GST tax exclusion only if the trust:

1. Is established for a single beneficiary who's a grandchild or other skip person,
2. Provides that no portion of its income or principal may be distributed to (or for the benefit of) anyone other than that beneficiary, and
3. Doesn't terminate before the beneficiary dies.

However, if you neglect to file gift tax returns, you may be saved by the automatic allocation rules, which are designed to prevent you from inadvertently losing the exemption. These rules automatically allocate the exemptions to direct skips as well as to transfers to "GST trusts." The definition of a GST trust is complicated, but essentially, it's one that meets certain criteria that create a strong possibility that the trust will benefit your grandchildren or other skip persons down the road.

Often, automatic allocation rules ensure that GST tax exemptions go where they'll be beneficial.

But in some cases, they may work against you. For example, the exemption isn't automatically allocated to transfers that may trigger costly GST tax. Or an exemption may be automatically allocated to transfers that are

unlikely to need its protection, thus wasting those exemption amounts.

REVIEW YOUR OPTIONS

To help ensure you use your GST tax exemption to the greatest advantage, examine all options closely. This is particularly critical if you want to make substantial gifts to skip persons or if transfers to a trust don't qualify for the annual exclusion (because, for example, they have multiple beneficiaries). Estate planning advisors can introduce you to tax-minimization strategies based on your unique needs and concerns.

Positioning your business for sale

Focus on value enhancement and tax reduction

If you own a business, it's probably your most significant asset, so you'll want to take steps to maximize its value when preparing for your eventual departure. There are many possible business exit strategies, including selling your business to a third party, selling it to your management team or transferring it to family members. Regardless of which strategy you choose, enhancing and preserving the value of the business will increase your chances of success. It's also important to consider the tax implications of a sale.

WHAT'S IT WORTH NOW?

The first step is to determine the value of your business today, ideally with the help of a qualified business valuation professional. Avoid the temptation to rely on industry rules of thumb, such as multiples of

sales or earnings. These formulas can provide a rough indication of value, but they're no substitute for a company-specific analysis by an experienced advisor. Prospective buyers usually evaluate businesses based on more sophisticated discounted cash flow or market comparison analyses, so it's a good idea to use similar techniques as a starting point.

Make sure your forecasts or projections of your business's future financial performance are solid and the underlying assumptions and calculations are accurate and well-documented. Consider obtaining a quality of earnings report to assess the accuracy and sustainability of reported earnings and the achievability of forecasted results. These reports, for example, distinguish earnings that are sustainable in the future from those that are attributable to factors such as nonrecurring revenues or below-market owner compensation.

HOW CAN YOU ENHANCE VALUE?

Conducting a valuation does more than provide an indication of what your business might sell for. It can also help you understand the factors that drive your business's value and identify weaknesses that can diminish it. Armed with this information, you have an opportunity to make changes that can increase value — and your business's selling price.

For example, a valuation professional might identify risks that reduce the value of your business in the eyes of prospective buyers or investors. Perhaps your management bench is thin or relies too heavily on your talents and ability. Maybe your information technology systems are outdated or your equipment is becoming obsolete. Or perhaps business is concentrated in a few large customers. With enough lead time, you may be able to mitigate these risks by bringing in new management talent, modernizing your technology and equipment, or diversifying your customer base.

WHAT ARE THE TAX IMPLICATIONS?

A complete discussion of the tax implications of a business sale are beyond the scope of this article, but there are a few things you should

CONSIDER AN ESOP

If you're an owner of a corporation, one exit option worth considering is an employee stock ownership plan (ESOP). This is generally a qualified retirement plan that invests in your company's stock. An ESOP can allow owners to:

- Start cashing out while still maintaining control over the business,
- Defer capital gains on the sale of stock to the ESOP, and
- Generate valuable tax benefits for the business.

For example, a company can deduct ESOP contributions used to buy stock. And if your company is an S corporation, income passed through to stock held by an ESOP avoids federal (and often state) taxes. Just be aware that ESOPs can involve significant expense, including annual valuations of the company's stock.

start thinking about. For one, if your business is organized as a corporation, selling stock is usually preferable from a tax perspective because stock sales are taxed at more favorable capital gains rates. An asset sale, on the other hand, may produce a combination of ordinary income and capital gain.

Plus, if your business owns a significant amount of depreciated equipment, an asset sale can result in depreciation recapture at ordinary income tax rates. With C corporations, asset sales can trigger double taxation, first at the corporate level and again when proceeds are distributed to shareholders. Keep in mind, however, that most buyers strongly prefer to acquire assets, since doing so generates larger depreciation deductions and makes it possible to avoid assuming the seller's liabilities. Similar considerations apply to businesses structured as LLCs or partnerships, although the tax rules can be complex.

Purchase price allocation is another issue to consider. In an asset sale, buyers and sellers have some leeway to specify how the purchase price is allocated. As a seller, it's preferable to allocate as much as possible, within reason, to assets that produce capital gains, such as goodwill and certain other intangible assets. (Note that buyers may have conflicting interests.)

To support your allocation, be sure to document the value of goodwill and other intangibles. If your business is a C corporation, you may be able to avoid some double taxation by demonstrating that a portion of the business's value is attributable to its owners' personal goodwill. Personal goodwill can be transferred directly from owners, bypassing the corporation.

START EARLY

To enhance the value of your business and ease the tax burden on an eventual sale, start the planning process early. These strategies can take time to implement. Talk to financial advisors with experience in mergers and acquisitions.

Is a Roth IRA conversion right for you?

Have you considered converting your traditional IRA into a Roth IRA? This strategy may offer several benefits, and it's available regardless of income level. However, a Roth IRA conversion isn't a no-brainer. Whether you'd be better off with a Roth IRA or a traditional IRA depends on your circumstances.

TAX NOW OR TAX LATER

Traditional IRA contributions can be deductible, but withdrawals of contributions and earnings are then taxable. Conversely, Roth IRA contributions are nondeductible, but qualified withdrawals of contributions and earnings are tax-free. As a general rule, deciding between the two depends on whether you're better off paying taxes now (Roth) or later (traditional).

When you convert a traditional IRA into a Roth IRA, you're immediately subject to income tax on the amount you convert that's attributable to deductible contributions and earnings. In other words, doing a conversion means paying tax now rather than later.

WHEN IT MAKES SENSE

A conversion might be the right choice if:

- You expect your taxes to be higher when you withdraw funds from the IRA in retirement because, for example, you believe your income will go up or Congress will increase tax rates.
- Your income in the current year has fallen into a lower tax bracket, providing an opportunity to do a Roth conversion at a lower tax rate.
- You have a tax situation — such as a large net operating loss or charitable deduction — that would offset taxable income created by a conversion.
- Asset values in your IRA are depressed — perhaps due to market volatility — reducing the tax cost of a current conversion.

Tax rates aside, there may be other reasons to pursue a Roth IRA conversion. For example, Roth IRAs aren't currently subject to required minimum distributions (RMDs). So a conversion would give you the flexibility to allow funds to continue growing tax-free indefinitely. And from an estate planning perspective, a conversion would allow you to pay the tax now, preserving the entire account balance for your beneficiaries.

ROLE OF QCDS

On the other hand, a traditional IRA may be preferable if you plan to make significant charitable donations. Starting at age 70½, you can make qualified charitable distributions (QCDs) of up to $100,000 per year from a traditional IRA. QCDs can be applied toward your RMDs and they're excluded from your gross income. So they may be more valuable than ordinary charitable income tax deductions.

Ultimately, the choice will hinge on your specific circumstances. Talk to your Lenox advisors.