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NEWSLETTER

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ESTATE PLANNING AND BUSINESS SUCCESSION PLANNING: HOW THEY INTERCONNECT

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The estate planning a business owner needs to engage in is often viewed as separate and apart from the business succession and transition planning that also needs to be done. However, the opposite is certainly true. A business owner may begin the planning needed for a successful transition away from the business but neglect to integrate his or her estate planning into this effort right from the start.

The following are several factors that need to be analyzed and addressed once the interconnection of estate planning and business transition planning is recognized.

<u>Growing the Estate Outside of the Business Interests</u>: For many owners of small to medium sized businesses, the value of the business comprises a very large percentage of the business owner's estate. It may range from 70% to 90%. When this scenario is understood, the owner may well begin to strategize how to extract cash from the business so that such cash can be invested in a portfolio of investment assets. The growth of this "investment portfolio" over time can provide the business owner greater flexibility when calculating how much the business must be sold for in order to obtain financial security in retirement. This "investment portfolio" can also provide the business owner with greater flexibility in determining how to "divide up" the estate among the children, especially when one child is involved in the business, and the other children are not.

<u>Deciding Who Will Control and Ultimately Own the Family Business</u>: A business owner, very early in the transition planning, must analyze and evaluate all of the various possible "buyers" of the business. These "buyers" can range from (i) a third party "buyer" introduced by a business broker or investment banker, (ii) a competitor, (iii) a supplier, (iv) key management employees, or, finally, (v) children involved in the business. This analysis becomes more problematic if the child (or children) currently employed in the business has expectations of receiving ownership of the business as part of his/her/their inheritance from the parents. Importantly, the analysis of each of these potential "buyers" will likely show a large difference of how much cash will actually be received at "closing," versus paid out over time either under a promissory note or as "earn outs."

<u>Achieving the Goal of Treating the Children Equally or Fairly</u>: When the business comprises a significant percentage of the parents' estate, and one child has been involved in the business for a long time and may be viewed as the "successor" or as one of the key employees viewed as the desired or likely "successors," the parents will likely face a

troublesome dilemma. How do the parents treat each child equally or fairly upon the ultimate distribution of the family's estate if it will include the family business? A key question is whether any part of the ownership of the business should be given to those children not involved in the business. However, when this scenario is reviewed, the parents will often see how likely it is for disputes and controversy to arise between those children not directly involved in the business and those who are. Consequently, this undesirable scenario will have to be weighed when analyzing various business transition options.

<u>Providing for the Income Needs of the Spouse and Dependent Children upon a Premature Death</u>: A business owner may actually start the estate planning process before the business transition process. When this occurs, the business owner may realize that while such owner is generating an income that supports a pleasurable life style while alive, that income stream will disappear upon a premature death (or disability). Thus, the business owner has to consider if the business will still generate sufficient income for the surviving spouse and dependent children by means other than wages. With an awareness of this uncertain scenario, the business owner may well begin evaluating whether the current management team will be able to continue the business without the owner. With this analysis, the owner may decide that the management team does need to be enhanced, either by training the existing management, or by bringing in one or more skilled and experienced managers who could take over the owner's duties and responsibilities. Alternatively, if the management team is viewed as being competent enough to continue running the business successfully, then maybe some deferred compensation plans need to be implemented to encourage and incentivize the key employees to stay on after the owner's death. Putting in place some "golden handcuff" plans will also likely be part of any business transition plan.

<u>Obtaining Asset and Creditor Protection</u>: As the estate of a business owner grows, so does the concern about asset and creditor protection. This issue is addressed at the very first steps of starting the business by selecting which type of entity should be created to "house" the business (e.g. whether it should be a corporation or a limited liability company). Then, over time, the concern over creditor protection becomes separated into two categories. First, is there a way to properly protect the assets held by the corporation, for example, from potential creditors and claims arising from the operations of the business? Second, with the appreciating value of the shares of the corporation, is there a way to protect those assets from creditors and claims arising from the personal actions of the business owner?

One scenario might be as follows. The business owner has concerns about the exposure of assets held within the business entity. Consequently, the owner decides to make distributions of cash from the entity that is otherwise viewed as not being needed for operations or expansions. The owner will be analyzing how to minimize the taxation of these distributions. This cash is then transferred into a domestic asset protection trust that is formed in a state that allows the grantor to be a potential beneficiary of that trust while still alive. In this way, the cash distributed to the owner is no longer exposed to the creditors of the business, and ultimately is protected from potential creditors of the owner. From a business transition perspective, withdrawing the cash from the business will typically reduce the fair market value of the business. This lower value may well make it easier for the key employee(s) of the business to purchase the business from the owner in the future.

As an alternative to an actual cash distribution to the owner, which will likely be taxable, the owner could form a captive insurance company. Importantly, the captive insurance company could ensure risks not otherwise insurable with existing commercial insurance companies, or provide increased coverage at lower premiums. Moreover, the premiums paid for the insurance provided by the captive insurance company will be deductible by the business. From an estate planning perspective, the business owner, rather than owning the captive personally, may decide to transfer some, or all, of the ownership interests into a dynasty trust for the benefit of his or her children. (Dynasty trusts must be formed outside of California.) Or, in addressing the issue of treating the children fairly, the beneficiaries of the dynasty trust may be only those children who are not involved in the business and who will not receive ownership interests in the business upon the death of the owner. Finally, from a business transition perspective, the owner may decide to transfer equity interests in the captive to key employees as a way to achieve long term retention.

The above discussion demonstrates how business transition and succession planning will likely raise issues and topics that will need to be addressed in the estate planning of a business owner. On the flip side, a business owner initially developing an estate plan will often realize the need for concurrently designing and implementing a business transition plan.

CALIFORNIA TO ALLOW FIDUCIARIES TO E-FILE

Beginning in 2014, California will allow Executors, Trustees, and other fiduciaries to e-file some income tax forms. E-filing will be permitted for the following forms: CA Form 541 (California Fiduciary Income Tax Return) and Schedules D, J, and P for that form, as well as K-1's for beneficiaries. While e-filing is not mandatory this year, it should result in quicker tax refunds.

U.S. SUPREME COURT TO RULE ON BANKRUPTCY PROTECTION FOR INHERITED IRAS

The U.S. Supreme Court has recently agreed to hear a case that involves an Inherited IRA and its potential protection in bankruptcy. The Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 protects IRAs from the claims of bankruptcy creditors up to $1 million (or all of it if the funds in the IRA were rolled over from qualified pension plans). However, there has been a great deal of uncertainty as to whether the relevant bankruptcy provisions not only protect the owner of the IRA, but also the named beneficiaries of that IRA upon the owner's death. Upon an IRA owner's death, the funds in that IRA are transferred by a "trustee-to-trustee" transfer into a new account (assuming a single beneficiary) established as an "Inherited IRA" with the custodian. Over the last several years there has been a significant split among the bankruptcy courts and the Federal Courts of Appeal as to whether the assets in an Inherited IRA are protected.

The case being heard is: *In the Matter of: Brandon C. Clark and Heidi Heffron-Clark v. William J. Rameker, Trustee,* as decided by the U.S. Court of Appeals, Seventh Circuit.

Brandon Clark and his wife Heidi Heffron-Clark operated a pizza shop that failed. They subsequently filed for bankruptcy protection from their creditors' claims. The Clarks owed approximately $700,000 to their creditors. Mrs. Heffron-Clark inherited an IRA from her mother worth about $300,000. The bankruptcy trustee (William Rameker) sought to seize the inherited IRA to help satisfy some of the creditors' claims. The Clarks argued that the inherited IRA was exempt. The Bankruptcy Court agreed with Rameker and ruled that the assets in the inherited IRA were not exempt, but the U.S. District Court reversed that ruling. However, the 7th Circuit U.S. Court of Appeals then reversed the District Court's order, ruling that the bankruptcy trustee could liquidate an inherited IRA to pay creditors' claims. This ruling is in direct conflict with decisions on the same issue by the 5th and 8th Circuits.

The Clarks appealed to the U.S. Supreme Court which has recently accepted the Petition. The hearing before the U.S. Supreme Court is expected to occur in March of 2014, with a ruling expected shortly thereafter.

Feel free to contact Bradford N. Dewan with any questions regarding the Inherited IRA issues described above.

A NEW YEAR'S RESOLUTION WORTH KEEPING: DO YOUR ANNUAL ESTATE PLANNING CHECK-UP

DeEtte L. Loeffler, J.D., LL.M. Taxation

The new year is a great time to pull out your estate plan and make sure it still meets your needs. Changes in assets, family, and your health (or that of your loved ones, fiduciaries, or prospective agents), are some good reasons to review your plan. In recent years, changes in federal or state property or tax laws have also made some estate plans less tax-efficient than they used to be.

Generally speaking, whenever you experience a major life change, you should review your estate plan. Major life changes include marriage, divorce, birth of a child, significant health issues, substantial changes in the value of your estate, or loss of a spouse, parent or issue. Do you need to add or remove a beneficiary under your plan? Are your agents still able and willing to serve? Should someone else be the agent (for example, a new spouse or your adult child instead of your parent)? If your plan does not include successor agents or trustees, should some be named now in order to avoid the need for court intervention at a later date?

The proximity of your agents to you is another issue to review. While naming a child to serve as your health care agent might have made sense when the child was local, it may make less sense if that child now lives out of state. Likewise, an agent who now has a very demanding job, travels a lot, or has become ill may no longer be a good first choice to assist you with managing your assets.

If you have experienced an increase or decrease in asset values during the past few years, your distribution scheme may also need to be revised. Specific bequests (gifts of sums of money or specific assets) are generally paid <u>before</u> gifts of the residue and can lead to unplanned results if the size of your overall estate has changed. Assets that are burdened with debt may also need to be reviewed. Remember that a reverse mortgage has to be repaid at the death of the borrower and can cause your heirs to lose the house unless you have a repayment plan in place. If you intend to gift specific assets to each child, you should review the value of these assets periodically to ensure the values of any of those assets have not changed significantly.

Changes in the law can also affect your plan. They may affect how your assets will be distributed or what benefits you have to give. Due to the ever increasing exemptions for gift and estate tax purposes, many estates no longer have to worry about paying an estate tax. With that in mind, some individuals may no longer need life insurance which was purchased for the sole purpose of paying the estate tax at death. Consideration should be given to either converting the use for those proceeds after death (such as identifying them to use in a business buyout), or terminating policies that have become expensive to maintain. **We recommend you never terminate a life insurance policy without first discussing this with a professional.**

Changes in the law can also affect how the assets are taxed, both during your lifetime and during the administration of any trust you establish. In 2013, income tax became a significant issue for irrevocable trusts. Additionally, increased state and federal income tax rates, the new Net Investment Income Tax on passive income, the new 0.09% Medicare tax, and other changes went into effect. Since some of these taxes will not even be collected until taxpayers file their income tax returns later this month, we anticipate many taxpayers will be displeased to learn they owe additional taxes for 2013.

In 2014, we recommend you look for ways to immediately reduce income taxes (as well as taxes that can be imposed on your estate and trust after you or your spouse die). Changing the manner in which assets will be distributed, or in which assets are currently held, can result in overall lower income taxes. For some individuals, immediate charitable gifting, combined with other techniques, can provide a current income tax benefit while providing tax free wealth replacement for assets gifted. Terminating or amending some irrevocable trusts, if permissible, may also provide income tax relief.

Finally, planning needs to change as we age. Those with very young children need a different estate plan than those with children in college, or those whose children are now supporting themselves. The same is true for business owners; planning changes as a company gets more established or as the owner prepares to transfer or sell that business. While the same basic components should exist in each estate plan (a trust, a Will, health care documents, and a financial power of attorney), there are significant differences in the needs of the parties involved. Looking at your current plan with these life changes in mind may help you to see where some changes ought to be made.

Make a resolution this year to help your family, and yourself, by reviewing your plan in January. Keeping your estate planning current is a gift you can make to your family, and it is something that only you can do well. Your attorney is generally not aware of all the changes in your life and cannot determine if particular changes in the law will affect your estate plan unless you contact him or her to request a review. Help yourself today by reviewing your plan and asking for guidance to address life's changes.

FEDERAL TAX UPDATE: TAX REFORM IN JEOPARDY

The movement to reform the federal tax code took a major blow in December when President Obama nominated Senator Max Baucus (D - Mont), Chairman of the Senate Finance Committee, to serve as Ambassador to China. Senator Baucus, along with House Ways and Means Committee Chairman Dave Camp (R - MI), have been very vocal in pushing for federal tax reform over the last 12 months. Promises by both men to provide bills out of their committees this fall failed to materialize due in large part to the government shutdown in October.

Although a 2-year federal budget deal was reached in December, tax issues have not yet been addressed, and now appear even less likely to be dealt with in early 2014. In addition to the loss of Baucus, Congress still has to deal with the National Debt Ceiling, which could be reached as early as February 8, 2014, although by employing "extra-ordinary measures," Treasury may be able to extend this deadline until March (and if sufficient tax revenues are collected, and refunds postponed, some think the deadline might be extended even longer).

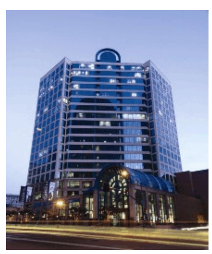
One tax issue still to be addressed is the expiration of over 50 "temporary" tax breaks that normally are renewed in December in a "tax extenders" bill. Several of these expiring breaks affect small businesses: Section 179 expensing (drops from $500,000 to $25,000); bonus depreciation; 5-year recognition of S corp built-in gains (goes back to 10 years); and 100% exclusions of gain on the sale of qualified small business stock.

We will continue to monitor federal tax legislation for changes that may affect your business.

STATE TAX UPDATE

No significant legislation has been proposed for 2014 that would either (1) change the way taxes are collected, (2) improve the business climate, or (3) raise (or lower) taxes in California. SB 323, the bill to strip the Boy Scouts and other youth organizations of state tax exempt status, was not adopted, but promoters have indicated they will bring it back in 2014. In addition, SB 622, which is designed to tax sweetened beverages to fund a report on childhood obesity, was not adopted, but Supervisor Scott Weiner of San Francisco intends to put the tax on the ballet at the city level in 2014.

In San Diego, controversy currently rages over the reimposition of a 1.5% “linkage fee” on developers of commercial and industrial projects to help pay for building low-income housing. The controversial fee was first imposed in 1990, then cut in half in 1996, and finally reimposed in full in 2013. A petition drive is currently ongoing to put the issue on the June 2014 ballot.



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