TAX AND WEALTH ADVISOR ALERT: SUCCESSION PLANNINGTHE THIRD SIN — “NOT TREATING A BUSINESS LIKE A BUSINESS"

The third sin committed in succession planning is when the business owner fails to treat the business like a business. This sin is a common one for closely-held businesses. Remember that the goal of succession planning is to maximize the value of the business to take care of the people that Mom and Dad care about. One potential way to maximize the value of the business is to sell it. In fact, in my practice, more than half the time, the parents’ exit strategy ends up being sale rather than intra-family transfer.

So to best maximize the purchase price for the sellers, we have to consider the mindset of the unrelated purchaser. Buyers will pay less when Dad makes all of the decisions, has all of the key relationships and runs all of the major processes. As a mentor of mine once sagely put it, “how much would you pay for the Michelangelo sculpting studio?” But, if the business is run through well-designed systems, systems that people can step in and run, a Buyer will pay more. Also, Buyers get nervous and have been known to back out of deals where key relationships are not tied down by contracts. Leases, critical customers and key employees should have contracts to protect the business and its value. A question I often ask clients is, with this relationship, what would the board of Apple do? If they would have a contract, then why not you?

So treat the business like a business—it will maximize the choices Mom and Dad have to use the business to take care of the people they care about.

TAX AND WEALTH ADVISOR ALERT: SUCCESSION PLANNINGTHE SECOND SIN — “MISTAKING FAIRLY WITH EQUALLY"

The second sin committed in succession planning is when the business owner acts too much like a parent and mistakes “fairly” with “equally.” The origin of this sin starts on the date the second child is born. As parents, Mom and Dad want to make sure each child knows that they love him or her “the same” as the child’s siblings. This need for equality begins to permeate every part of the parent-child relationship. Many a parent has said “I need to coach Susie’s dance team because I coached Johnny’s soccer team,” or found themselves

running out on Christmas Eve to purchase one last silly gift just to “even things up.” So when it comes to the estate plan, it is not surprising that most parents decide to leave everything equally to the kids. And if the parents are business owners, that oftentimes means leaving the business equally to the children; to some who are involved and some who are not.

The problem with equally is, counterintuitively, it is a selfish notion. It is born of well-intentioned parental guilt: I do not want any of my children to think I love them less, and they cannot if I treat them all the same. But what is missing in that reasoning is what the child really wants. Does the uninvolved child really want an equal amount of stock in a business that he/she does not know or care about? Or would the child rather have cash or mutual funds worth less, but that are easily usable to meet the child’s wants and desires? The key to avoiding sin #2—ask yourself what does each child want, and if possible, try to design a plan that gets those children what they want without worrying about whether each child gets the same amount. Be fair, not necessarily equal.

TAX AND WEALTH ADVISOR ALERT: THE SEVEN DEADLY SINS OF SUCCESSION PLANNING

Over the next few weeks, this blog will analyze the Seven Deadly Sins of Succession Planning. And what are those sins? They are the mistakes business owners make in attempting to make the transition of their closely-held business successful. Why do they make them? They forget the most important fundamental that their estate plan needs to be a plan that will take care of the people they care about. This can be accomplished by getting the right stuff to the right people at the right time. And they do it through maximizing the value of that stuff.

This blog will focus on these mistakes, why they are so common, and most importantly, how to avoid them.

THE FIRST SIN—”Not Putting Leadership First”

The first sin committed in succession planning is when the business owner does not place the leadership of the company as the highest planning priority. A succession plan is an amalgam of the company’s leadership succession strategy and the owner’s estate plan. The succession plan and the owner’s estate plan should have the same central focus. The business’ leadership succession strategy should be focused on choosing the best leader to maximize the value of the business. The owner’s estate plan strategy should be to take care of the people they care about. Furthermore, the plan should be executed by maximizing the

value of the property the business owner leaves to take care of those people. And with most business owners, the bulk of their property is tied up in their businesses.

So putting these two things together, the best estate plan requires a successful leadership succession strategy. Simply put, before addressing matters like dispositive strategies, tax planning, or asset protection, the business owner needs to make sure that the right people are empowered to make the right business decisions when the owner can no longer make those decisions. Stated another way, if the wrong leader runs the business into the ground, what assets are there to protect or what value is left to tax?

Are your succession planning advisors putting first things first? Or, are they running elaborate spreadsheets with intricate tax analyses before they help you with THE threshold question: If not you, then who? A successful succession plan requires answering that question… and answering it FIRST.

TAX AND WEALTH ADVISOR ALERT: IRA DISTRIBUTION: THE GOLDILOCKS RULE

Understanding the rules of IRA distributions is like taking a trip through our childhood. Remember Goldilocks and the three bears? Too hot, too cold, just right? IRA distributions work a sort of the same way.

Cannot Be Too Early

IRAs were created by Congress to be retirement savings vehicles. Because of that intent, Congress (through the tax code) penalizes distributions from IRAs that are “too early.” Too early is generally when the account owner is younger than 59½. The consequence of taking distributions too early is that when the account owner receives the distributions from the IRA, not only will the distributions be taxed at ordinary income rates, an additional 10% penalty will apply. There are some exceptions to the 10% penalty; most of which the account owner cannot plan for (death, disability) and others which are really not all that helpful (substantially equal payments over the owner’s life expectancy).

Cannot Be Too Late

The power of the IRA is tax-deferred growth. The so-called Rule of 72 is supercharged when earnings can grow without the drag of income taxes. But always remember, when it comes to tax advantages, the government tends to see the taxes we save as its lost revenue. And it

only delays receiving “its revenue” for so long. With IRAs, that time of reckoning comes on April 15 of the year after the year when the account holder reaches 70½. Thereafter, each year, the account holder must take what are known as required minimum distributions.

Cannot be Too Little

At 70½, account owners need to take required minimum distributions; any distributions that are less than that are penalized. Required minimum distributions are calculated based upon the life expectancy of the account owner. That life expectancy gets recalculated every year. The essence of recalculation is that even though the percentage of the account balance that must be distributed each year increases (due to the lessening of the account owner’s life expectancy), it will never require the distribution of the entire account balance during the account holder’s lifetime.

Cannot Go On Forever

While recalculation of life expectancy of the account owner means the IRA will never be depleted by required minimum distributions during the account owner’s lifetime, the same cannot be said for periods after the death of that person. If the IRA is left to the surviving spouse, the spouse also gets the benefit of annual recalculation. However, if the IRA is left to someone other than the surviving spouse, the best that beneficiary can hope for is the use of his or her life expectancy at the time of inheritance for the calculation of IRA distributions. That life expectancy will not be recalculated. So, for example, if an IRA is left to a child with a 30 year life expectancy, that child must receive 1/30th of the IRA the first year, 1/29th the second year and so on until the balance is distributed in the 30th year following inheritance. It is in that 30th year that the IRA will no longer be allowed to exist as a tax-free accumulation vehicle. (For more information on so-called stretch planning strategies for inherited IRAs, please see other articles on the website dedicated exclusively to this topic).

So when it comes to retirement, IRAs can be powerful planning tools. But like Goldilocks, there are a lot of restrictions in getting your clients’ plans “just right.”

TAX AND WEALTH ADVISOR ALERT: ROLE OF A REVOCABLE TRUST IN AN ESTATE PLAN

The revocable trust is the document that is almost always the centerpiece of the estate plan. Simply put, the revocable trust is almost always the document that controls who gets what.

That might be counterintuitive to some people who assume the Will is the “dispositive document.” But, most often, the Will serves only two purposes: (1) It is where clients nominate the person or persons who will raise their minor children, and (2) it is the clean-up document which transfers any property that has inadvertently not been otherwise transferred as part of the estate plan. In other words, other than the critical, crucial role of naming the so-called guardian of minor children, if the planning has been done correctly, the Will is irrelevant.

Let’s take a step back—how can that be? Isn’t the Will THE document that states who gets property when someone dies? First, if the property transfers by either title or contract, it is that title or contract (not the Will or trust) that determines who gets that property. For example, if Mr. and Mrs. Smith own their house as joint tenants with the right of survivorship, and Mr. Smith’s Will provides that his interest in the house goes to his son upon his death, then if Mr. Smith dies first, Mrs. Smith will own the entire house. Given the titling of the property, the survivor—in this case Mrs. Smith—is the sole owner upon the death of the joint tenant (Mr. Smith). So even though Mr. Smith’s Will attempts to transfer one-half interest in the house to his son, the title trumps that intent—making the Will, as to the house, irrelevant.

Second, if property is transferred by contract, it is the contract rather than the Will (or trust for that matter) that controls who gets that property. For example, let’s say Mr. Smith owns a stock brokerage account. Mr. Smith completes a beneficiary form leaving the stock account to his son. Later, Mr. Smith remarries and thereafter has a falling out with his son and disinherits him under his Will. When Mr. Smith dies, who gets the stock in the brokerage account? The answer is, his son—the property passes by contract, so the contract, not the Will, controls. The contract says that the account goes to Mr. Smith’s son at his death. Again, as to that account, the Will is irrelevant.

Finally, it is inevitable that the client will own some property that does not pass by either title or contract. So that property will pass by Will, correct? The answer to that question is yes; if our client, Mr. Smith, dies owning property—property that does not pass by title or contract—it will pass by his Will. But the goal of our estate plan is to have Mr. Smith die owning no property—at least no property that does not pass by contract or title. But why?

If Mr. Smith dies owning property that does not pass by title or Will, that property generally must go through the process of probate before it gets to its intended recipient. So what is probate? Essentially it is a public process wherein what you own and who you owe is filed with the court and becomes part of the public record. For some people, the lack of privacy in that process is troublesome. For others, that is not an issue, but the cost and delay of the probate process is problematic. Generally, all things considered, most clients decide that probate is to be avoided rather than embraced. But the only way to avoid probate is to die owning nothing, nothing other than assets that pass by title or contract. Is that practical? It is if you transfer all of those assets to a revocable trust.

A revocable trust is a trust controlled by the client. So if Mr. Smith creates a revocable trust, he will be able to access that trust property any time he wants, for any needs or desires he has. He will be able to change the trust and terminate the trust any time he chooses. From a practical perspective, a revocable trust is identical to outright ownership. But the advantage is that, legally, it is not ownership and any asset in the trust does not have to go through probate. If all of Mr. Smith's assets—those that do not pass by title or contract—are in his revocable trust—he avoids probate. And again, all things being equal, that is a good thing. Finally, the trust would provide who gets the property upon Mr. Smith's death—it can be worded identically to how he would draft his Will. For example, the trust could provide that, at his death, the trust property is distributed equally to Mr. Smith's children.

So that is the revocable trust in a nutshell; the centerpiece of the estate plan.

TAX AND WEALTH ADVISOR ALERT: DO I NEED A WILL AND WHY?

As an estate planning attorney, the most common question I get—both from potential clients and at cocktail parties (or kids' soccer games)—is, "do I need a Will?" Now, I know that a lot of estate planners have a simple, consistent three letter answer for that is, "YES". But that is not my answer. My answer, maybe a typically frustrating lawyer answer is, "it depends."

So let's say a potential estate planning client, John, has asked me that exact question— do I need a Will? The first question I will lob back to my new inquisitive friend, is does he have minor children? If the answer is yes, my questions are complete and my answer is "yes, you need a Will." Why, might you or John ask? Well, what is more important to a parent than who will raise his kids if he (and his wife) cannot? The answer is nothing. Who makes that decision? In other words, if John and his wife get into a fatal car accident on the way home from dinner that night, who will decide who gets to raise his kids? The answer is, under all circumstances, a judge…A probate court judge. The next question is how will the judge make that decision? Well, from experience, I will tell you what the judge hopes will be in place to aid in making that decision: a nomination of a guardian in John's Will. The Will is the only document in which John can nominate a guardian for his children; if there is no Will, regardless of whether John has written down his hopes on another document, the judge will be on his or her own in making the decision. Therefore, if the answer to the question, "do you have minor children?" is "yes," then the answer to whether "you need a Will" is also "yes."

But what if the answer is no—what if John and his wife do not have minor children—does he

need a Will? The second question is, in general, who do you want your property to go to? You see, even if John does not have a Will, he does have an estate disposition plan that dictates where all of his property will go when he dies. It is just not a plan he has created. Instead, it is a plan created by the state in which he resides under that state's "intestacy" law . While each state's law is different, generally, the intestacy laws provide that, first, everything goes to the surviving spouse; if no spouse, then equally to the kids, then if no kids, to the grandkids, if no grandkids, to parents, then siblings, then nieces, and nephews, then cousins. So, if John wants everything to go to his wife when he dies, does he need a Will? Maybe not. But what if he and his wife die together, in a common accident? Given they have no chidren, everything he owns goes to his parents. And if his wife outlives him, everything they own goes to her parents. Is that what he wants? Is he okay with that? If so, he does not need a Will. But if he is not, then, yes, he does need a Will.

Finally, even if the intestacy statutes work in general, I need to make sure they work specifically. For example, let's say John was not married but rather a 70-year-old widower with three adult children. Who does John want the property to go to? Equally to his three kids. If he had no Will, where would his property go? Equally to his three kids. Seems like he does not need a Will. But what if he wants specific property to go to specific people? Maybe John has some real estate investments, and he has a child that has strong acumen and passion in real estate development. And, he also has a stock portfolio with a child who is talented in managing and trading equities. Remember an estate plan gets the right property to the right people. Intestacy laws give the kids 1/3 of each asset—only a Will gets the right property to the right people. So if that is the case, and John wants to get specific property to specific people, he needs a Will.

So your client asks, do I need a Will? Don't be a sheep and simply say "yes." Be an advisor and ask:

1. Do you have minor children?
2. Who do you want your property to go to?
3. Do you want specific property to go to specific people?

The answers to these questions will drive the answer to your client's question.

TAX AND WEALTH ADVISOR ALERT: KEEPING IT IN THE FAMILY

For those of you who spend time in the estate planning arena, in helping your clients get the

right property to the right people at the right time, you inevitably run into “the conflict”: The conflict between the mathematical truth that it is better, tax-wise, under virtually all circumstances, to have your clients give away property as soon as possible: and the reality that people are (and should be) reluctant to cede control over their wealth, which they generally worked very hard to build. The problem with this conflict is that we as planners tend to fall too quickly and easily into what business consultants call “the tyranny of the or.” We concede that the math and the control are mutually exclusive. But, luckily, that is simply not true.

Let’s assume that our clients are a successful couple in their early 50s. Their net worth is $8 million. If they die without any growth in their combined estate, they owe no estate taxes given the $5 million (indexed) exemption. But if they do not both die soon, their assets could increase in value to more than $10 million (indexed), the amount that they could exclude from estate taxation, under current law, working together. In fact, if we assume that their assets will grow at a 6% rate and that the survivor will live into his or her mid-80s, the million should double in value 3 times – to 14 million, then 28 million then 56 million.

Even with modest appreciation, then our clients will have a large estate tax bill. And if the $7 million is in assets that would be hard to sell quickly (such as real estate), or that we do not want to have to sell (such as a family business), the estate tax problem could get to be difficult and expensive to solve.

But right now, we have a great solution. We can have Mom and Dad make a gift right now, in an amount equal to the current gift tax exemption, while keeping enough to live comfortably. In other words, they can give away “the extra” (the property that is more than what they believe they will need to live comfortably); or, stated another way, those investment assets that they will never need to touch, based upon reasonable projections.

The problem is again, at least in my world, not a lot of this kind of planning is getting done. SO the question is, why not? While the answers to that question are probably as varied and as numerous as the people who answer it, the answers tend to boil down to these two themes:

1) We recently experienced, as a country, one of the worst economic stretches in our history. From late 2008 through early 2009, what felt like “enough” became “not enough” almost overnight. Having just experienced that national economic nightmare, people are less willing to part with what seems to be “the extra.”
2) Even if our clients had not just survived the Great Recession, andeven if they did have some level of confidence, people in their mid-50s, with at least 30 years of life expectancy in front of them, are reluctant (to say the least) to relinquish control over a portfolio they’ve worked a lifetime to build.

So are we back to the beginning? Do we have that common planning tug of war: The raw, compelling math that screams, “should clients give it away?” versus pulling against the raw human fears of losing control and becoming a pauper?

The difference is that we have an intelligent solution that guides our clients away from the tyranny of the or. Let’s go back to our $8 million example and let’s assume Mom and Dad believe that, based upon their lifestyle and growth assumptions, they will conservatively need $2 million to live comfortably. Therefore, using our terminology, $6 million is the extra. So let’s take that $6 million and title it in such a way, that under state law, half of that property is owned exclusively by Mom and half is owned exclusively by Dad. Dad, then, using his gift tax exemption, will give his property to a trust. Under that trust, Mom will have the right to control, enjoy, and transfer the property. And then Mom will do the same thing: transfer her property to a trust designed for Dad’s benefit.

If we do this, the $6 million is out of Mom and Dad’s estate. When they die, presuming that they consume the income and growth on the $2 million they keep, they will owe nothing in estate taxes. The trusts, who own the $6 million, and the appreciation on that property, are designed to avoid estate inclusion; in fact, they can be designed as dynasty trusts to avoid estate inclusion forever.

In discussing this idea with thoughtful and curious clients, inevitably those clients will raise a couple of issues or concerns, such as:

1. What if Dad and Mom get divorced? Generally, upon divorce, the judge will divide the marital assets equally between the spouses. So, if we did nothing, the family court judge would take the $8 million of property that Mom and Dad own and divide it equally, $4 million to each. If we do engage in our plan, the judge will take the $2 million that Mom and Dad own and divide it equally between them ($1 million to each), and each spouse will continue to control the trust created by the other spouse. Assuming no growth in the trust assets, each would have control over an additional $3 million. At the end of the day, each would control $4 million, with only $1 million being subject to estate tax. In other words, even in divorce, both are in a better situation then they would have been in has they not engaged in our plan.
2. What if Mom or Dad dies? If we do no planning, Dad and Mom collectively had control over $8 million. After the gifts, assume Dad dies, Mom would have control over the $2 million outside of the trusts and the $3 million in the trust Dad created for her. As to the trust she creates for Dad, she would have no control over, or access to, the property in that trust. So it appears that, upon Dad’s death, Mom has a reduction in the property over which she has control.

   On that point, the first thing to remember is that the property in the trusts is “extra,” property Mom and Dad really had no intention of tapping into. Stated another way, Mom and Dad believed that $2 million was a sufficient amount for the two of them to live out their lives comfortably. Now, if we do nothing, Mom has more than twice that amount

($5 million) to rely on. She should be just fine. But, if Mom and Dad are concerned, they should remember that the property in the trusts are extra, and therefore, chances are they will not be tapping into that property in a way that will stunt its economic growth. So if the property grows at 6, and Dad lives another twelve years the chances of which are very good), then Mom will once again have control over $8 million; $2 million outside of the trust and $6 million in the trust she controls. And, to hedge against asset underperformance and/or Dad's early demise, Mom can use the property in the trust Dad created for her to purchase a life insurance policy on Dad's life which could literally ensure that she will always have access to $8 million of property.

Finally, in implementing this good idea, it is critical to work with competent legal counsel who has wisdom and experience in trust design and the reciprocal trust doctrine. The trusts created by Mom and Dad can be (in fact, will be) similar. But they cannot be identical and wise counsel will know where the key differences in the trusts need to be.

TAX AND WEALTH ADVISOR ALERT: STATE OF CELEBRATION CONTROLS—ONE OPEN QUESTION FROM WINDSOR IS RESOLVED

The United States Supreme Court issued a landmark decision in Windsor, holding that if a couple is married and resides in a state (or province) that allows same sex marriage, then that couple is married for purposes of federal law (including the Internal Revenue Code). A question left unanswered by the Supreme Court in Windsor was, if a couple got married in a state that allows same sex marriage (the state of celebration), but resides in a state that does not allow same sex marriage (the state of residence), how is the couple treated under the Internal Revenue Code?

Luckily for planners, the IRS jumped into this definitional void. In Revenue Ruling 2013-17, the IRS makes it clear that it will administer the Code looking solely to the state of celebration. So if a same-sex couple marries in Massachusetts (a state that recognizes same-sex marriage), and then moves to Wisconsin (a state that does not recognize same-sex marriage), for federal tax purposes, the couple is married. Of course, for state tax purposes, the couple will not be treated as married, leading to challenges for planners who will need to consider state tax consequences that differ from federal tax consequences in planning for their same-sex married clients.

TAX AND WEALTH ADVISOR ALERT: IRS PROVIDES RELIEF FOR SURVIVING SPOUSE TO ELECT PORTABILITY

2010, as part of the Job Creation Act, Congress allowed a surviving spouse to utilize a previously deceased spouse's unused estate tax exclusion. This planning technique is known as "portability." In 2012, as part of the American Taxpayer Relief Act, portability became permanent (or as permanent as any federal statute can be). One of the requirements for portability is that the first spouse to die (the "decedent spouse") needs to file a Form 706 estate tax return and elect portability, prior to death; based on the value of the estate, filing an estate tax return would not otherwise be required. In other words, if the first spouse to die did not file a 706 prior to death, portability is lost.

At least that is what planners thought until the IRS issued Revenue Procedure 2014-18. In that Revenue Procedure, the IRS states that:

1. If a decedent died after 2010 and before 2014,
2. That decedent was a citizen or resident of the US upon his or her death,
3. The decedent's estate was not required to file an estate tax return based on the value of the estate (and taxable gifts), and
4. The decedent's estate did not file a timely return electing out of portability then, prior to December 31, 2014, the estate can file a form 706 and that return will be deemed properly filed.

TAX AND WEALTH ADVISOR ALERT: ESTATE PLANNING AFTER WINDSOR

The federal tax code (the "Code") offers several benefits (and a few burdens) to married couples. In 1996, the United States Congress passed a statute known as the Defense of Marriage Act ("DOMA"). Under DOMA, with respect to any federal statute, a married couple meant a husband and wife; a man married to a woman. Because the Code is a collection of federal statutes, same-sex couples legally married under the laws of a state that provided for same-sex marriage received none of the benefits provided to married couples under the Code.

One of these benefits the Code provides is the unlimited marital estate tax deduction: Under the Code, one spouse can leave an unlimited amount of property to the other spouse without the imposition of estate tax. Edith Windsor and Thea Spyer were a lesbian couple married in Ontario, Canada in 2007. In 2009, Spyer died and left her entire estate to Windsor. At the time of Spyer's death, both Windsor and Spyer were residents of New York, a state that, at that time, had legalized same-sex marriage and legally recognized same-sex marriages entered into in other states and countries. So, at the time of Spyer's death, under New York law, Spyer left her entire estate to her spouse. But under DOMA, Spyer did not leave everything to her spouse; Windsor could not qualify under the Code as Spyer's spouse as they were both women. Windsor filed her tax return, paid the estate tax and then sued for a refund, arguing that DOMA was unconstitutional. The District Court and the Second Circuit Court of Appeals agreed with Windsor.

The case was then argued in front of the United States Supreme Court. In a landmark decision, the Supreme Court determined that DOMA violated Windsor's and Spyer's constitutionally protected right to equal protection. In essence, the majority opinion held that historically, the definition of marriage is a matter left to the states. In passing DOMA, Congress violated that tradition of state-defined marriage. That departure was due to Congressional bias, and that bias violated the equal protection clause of the US Constitution.

The majority opinion answered this question: If a same sex couple is married in a state that defines same sex marriage as marriage, how is that couple treated for federal purposes (including the tax code)? The answer is clear: The same as any other married couple. But the decision leaves at least two other critical planning questions unanswered: (1) If a couple gets married in a state that allows same sex marriage, but moves to a state that does not, how are they treated for federal purposes, married (consistent with the laws of the state where the marriage took place, or what sometimes is called the state of "celebration") or unmarried (consistent with the laws of the state of domicile which does not allow same sex marriage?) (2) Can a state disallow same sex marriage if, in fact, that disallowance is a violation of equal protection? Hopefully, these questions are resolved in the future.

So after Windsor, estate planners should handle planning for a same-sex married couple in exactly the same fashion they handle planning for a heterosexual married couple. The planner should help the couple build a plan that takes care of the people they care about. The plan will accomplish that goal by getting the right property to the right people at the right time. The plan will ensure that the right people are making the right decisions. And the plan will be allowed to take advantage of the tools provided under the Code to married couples including (but not limited to) the unlimited marital deduction, income tax free transfers, and the ability of an inheriting spouse to treat the transferring spouse's IRA as his or her own.