Estate & Family Legacy Planning

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Family Business & Philanthropic Planning

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PASSING THE FAMILY BUSINESS WITH A CHARITABLE REMAINDER TRUST

By: Dana L. Mark

A question for our readers: A charitable remainder trust can (a) benefit family members, (b) benefit charity, (c) help diversify assets in a tax efficient manner, or (d) all of the above? The answer is (d).

A charitable remainder trust ("CRT") can provide you, your spouse, or other beneficiaries with lifetime income (annually either a fixed amount or a percentage of the trust's value (which will increase or decrease as the value of the trust changes)). When your interest in the trust ends, the balance remaining passes to charity. At the time you set up the CRT, you receive a charitable income tax deduction for the value of the charity's interest.

Significantly, a CRT is a tax exempt entity. As such, if you contribute appreciated property to the CRT, the sale of the property by the CRT does not incur income tax, i.e., capital gains tax can be avoided on such donated assets.

Consider the use of a CRT to provide a succession plan for your family business and to accomplish the following:

- Provide retirement security to the senior generation;
- Transfer ownership of the family business to the younger generation;
- Transfer ownership at a minimum transfer tax (estate, gift and generation-skipping transfer ("GST") taxes) cost;
- Satisfy philanthropic goals; and
- Obtain income tax benefits along the way.

For example, take Fred, age 68, who was the sole shareholder of Bedrock Inc., a corporation which provides marble, granite, and other high end stone finishes to builders. Fred's son Jim was recently made president of the company, and was fully prepared to lead the company in the future. Son Jules was a constitutional law professor and had no interest in the family business.

Wilma, age 62, Fred's wife, and the mother of Jim and Jules, was thrilled at the idea that Jim would take over the business and allow Fred to begin his retirement. Her biggest concern was assuring that she and Fred would be sufficiently provided for.

The business was valued at $50 million. Fred's basis in his Bedrock shares was nominal and therefore a sale by Fred would cause significant capital gain. So Fred and Wilma decided to establish a charitable remainder trust, and retained the right to receive annually 6% of the fair market value of the assets of the trust. Fred gifted 95% of his Bedrock shares to the CRT (as a gift, the CRT's basis in the stock was the same as Fred's). Consequently, for the first year the couple would receive $2,850,000 based on the value of $47,500,000.

Fred's remaining 5% of Bedrock, before discounts for lack of control and lack of marketability, were worth $2,500,000. After applying a 30% discount, Fred gifted Jim his shares with a gift tax value of $1,750,000, well within Fred's available $5,430,000 gift tax exemption.

About two years after the shares were transferred to the CRT, the board of directors of Bedrock decided to redeem 95% of its outstanding shares for its then current fair market value. At that time, the business was worth $58 million, and 95% was, therefore, worth approximately $55 million.

Bedrock made its redemption offer to Jim and the CRT. The CRT accepted the $55 million offer, which Bedrock could afford, partially out of its retained earnings and partially through a bank loan. The company's cash flow was such that it could comfortably repay the bank over a reasonable period. As a result of the redemption, the CRT ended up with $55 million in cash to invest, and Jim ended up as the sole owner of Bedrock. The CRT, being exempt from income tax, paid no income tax on the redemption, i.e., it kept the entire $55 million it received. With the $55 million in the CRT, Fred and Wilma would now receive $3,300,000 annually. Moreover, Fred and Wilma were able to assure that Jim obtained sole ownership of Bedrock, without incurring gift tax.

The major loose end is the fact that on the death of the survivor of Fred and Wilma, the trust fund will pass to charity. The answer is for Fred and Wilma to establish a life insurance trust which will purchase an insurance policy on their joint lives, payable to Jules upon the survivor's death. The annual payment from the CRT will provide Fred and Wilma with sufficient cash flow to afford the premiums on such a policy. With Jules as the beneficiary, the insurance proceeds will allow Fred and Wilma to treat their sons equitably.

Dana L. Mark focuses her practice on tax, estate and trust planning, charitable giving, and tax-exempt organizations. She has extensive experience involving sophisticated tax planning, the probate and administration of estates and trusts, qualified retirement plan assets and IRAs, and the preparation of pre- and post-nuptial agreements.

Dana advises executors and trustees in the administration of estates and trusts from the initial probate to the preparation of estate tax returns, fiduciary income tax returns, the preparation of accountings, and the settlement of the estate or trust. She also represents beneficiaries.

Dana has assisted families with the tax-efficient transfer of wealth, including planning matters involving the family businesses. She works closely with family advisors in designing and implementing succession plans.

INSIDE OUT: RETHINKING ESTATE PLANNING FOR FAMILY BUSINESSES

By: Roy P. Kozupsky, Esq. & Amelia ("Amy") Renkert-Thomas

Estate planning for family business owners is big business for many wealth advisors. Fueling this area of work is a combination of factors including the historically large (and at least for now increasing) federal estate tax exemptions. Congressional leaders, in their redundant debate, perennially raise the possibility of changing the estate tax regime. Both sides seem politically persuasive. The left argues that tax revenues are needed and warns that large amounts of wealth being transferred to future generations will create a dynastic social atmosphere that will weaken the entrepreneurial fabric of America's culture. The right is less strident, but the Red States' populist electorate and the ongoing need for tax revenues suggest that the estate tax will not be repealed any day soon. This tumultuous political debate about rates and exemptions is wonderful fuel for those ever-present human emotions of opportunity and fear, which seem to be the active ingredients in motivating families to consider transferring their wealth, including the family business, to their descendants.

But unfortunately, this political debate over taxes has turned the process of succession planning inside out. Too many families, especially those families whose wealth is denominated through their family business, see estate planning as primarily an exercise about reducing taxes, rather than planning for the future ownership and leadership of the business.

Helping a family wade through the myriad issues it faces in trying to sustain a business enterprise past even one generation certainly requires good estate tax planning – not adequately preparing for estate taxes can threaten or force the sale of a business. Unfortunately, consumer-driven decisions about which advisory services to purchase in this process lead many business families to fall prey to a far too narrow definition of "estate planning" and an even narrower definition as to which advisors might be in the best position to assist a family in navigating through the succession planning process for its family enterprise. Thus, it is no surprise that given all of the political debate noted above about estate taxes, the starting point for many families to engage in the succession planning process was simply estate tax avoidance. Families seeking counsel quickly become intoxicated with the tax acronyms that promise to mitigate the pain of impending estate taxes – FLPs, GRATs, CLATs and IDGTs, just to name a few. These planning strategies indeed can be valuable tools to integrate into the family's planning process.

The problem is, estate planning to mitigate anticipated taxes is not the beginning of the succession planning process – it's the end. The process as undertaken by most business-owning families unfortunately all too often is inside out.

Too many families with significant business interests fail to get the advice they need to understand the balance needed to perpetuate their legacy. Good tax planning is valuable, but more so when it is combined with a thorough understanding of the needs and objectives of the family and the business. Thus, understanding and articulating the family's succession planning objectives may be just as valuable as a sophisticated tax planning strategy.

Succession planning for family and business capital

Traditionally, wealth transfer planning for family owned enterprises has focused on three main questions for families to consider tackling:

- Which member of the family will run the business?
- Who will own the shares?
- How can we mitigate estate taxes on the transfer?

But, estate planning, which focuses solely on legal structures, can create unintended consequences of which controlling owners of family businesses and their estate planners will want to be wary, especially for businesses passing from the founder (or, a controlling owner) to a group of siblings or cousins. This is because estate planning changes the balance of an existing system – new owners enter the family stage in the form of LLCs, trusts, family limited partnerships and even philanthropic foundations.

Business decision-making both during and after the founder's departure is much more complicated, and yet founders and estate planners alike often fail to appreciate the new and different family-business systems their documents will create. The use by the legal profession of sophisticated trusts, even in the embryonic stages of family wealth planning, hatch a unique and complex set of long term planning issues that families need to consider.

A founder who takes a wider perspective and considers the financial, human and enterprise capital that is embodied in the business and the family might conclude that identifying a CEO candidate and preparing an estate plan are necessary steps, but by themselves, they aren't sufficient to sustain and grow the business and the capital in the next generation. Leadership succession planning that focuses only on the CEO role ignores other critical roles in the family business system – director, trustee, owner, forum leader – and fails to consider the work that will need to be undertaken to build a new decision-making system among management, board, owners and family once the controlling owner no longer sits at the center of business decision-making. Ownership succession planning that assesses assets purely by their monetary value and focuses on transferring them in the most tax-ef-

ficient way ignores human and enterprise capital, with the consequence that complex ownership structures such as irrevocable trusts, may achieve tax goals while missing non-financial objectives entirely.

A founder considering succession planning for the financial, human and enterprise capital of the business and the family should instead ask four questions:

- What is our capital? What human and enterprise capital have we created that is most important to us? What role does our financial capital play in our business and our family? What is our vision for the future?
- Who will follow me in the work of sustaining and growing the capital as well as the business? How can I engage the talents, skills, interest and enthusiasm of my entire family in sustaining and growing the capital and the business?
- What roles will they play in carrying it forward? Who has the ability, interest and availability to serve in management? As an engaged owner? As trustee? As a director?
- How can I help them prepare to take over?

A founder who recognizes all the capital embodied in the business and the family (human, enterprise and financial) and hopes to leave a system that can sustain and grow that capital will conclude that succession planning as it is typically thought of leaves too much of the real work of succession to those who will follow.

Expanding the team

The key to enhancing the successful transition of any family enterprise is vision and preparation, and the odds can be improved significantly by expanding the advisory team to include specialists in family relations and governance. This requires a deep commitment to creating an atmosphere of trust in which both the family and the advisor team understand the value of collaboration.

All too often, though, collaborative endeavors fail to take root in the estate planning process. Our hunch is that families don't think about expanding the advisor team mainly because of cost and also because they have rarely seen it utilized or offered as a comprehensive service. While families are used to paying for advice, they are not used to having succession and estate plans reviewed by different professionals who might have different values, skills and perspectives to add to the planning process. So, education about this is key, and not just for families: educating both the family and the advisors right from the inception of an engagement about the need and value of professional collaboration is an important process (and a challenging endeavor) in itself and will hopefully steer the professionals away from their natural tendency of working alone with clients. Surgeons don't operate alone. Pilots don't navigate their aircraft in a vacuum. Those professionals that service families in respect to their business planning need not only to recognize but also adhere to a higher level of collaboration despite the many frustrations that can easily emerge among different service industries.

When a business is run by a founder, decision-making operates like a hub and spoke – with the founder in the center of the action. The system is simple: all questions gravitate to and emanate from the center. But estate planning, especially wealth transfer planning with family owned enterprises, invariably builds a new system with multiple decision-makers. Once the plan takes effect, the founder will no longer be in the center; other decision-makers will emerge. The board of directors (if there is one) will need to take a new look at finances and strategy. Trustees, suddenly born out of the estate tax planning process and having their own set of fiduciary priorities, are thrust into a family's business ecosystem, all too often without proper training or education. Management will need to adjust to a new leader and new priorities. Family members will be in entirely new roles – one may step up to the CEO position, others may join the board, serve as trustees, or even be beneficiaries of new trusts which own illiquid non-voting business interests. As they take these roles, they will need to ask questions, learn new skills and develop very different ways of relating to each other.

The challenge for business-owning families is that estate planning documents that are fundamentally tax-driven don't begin to address the new complexity of the family business system. Founders and their family members need help understanding the new roles that the documents will create. They also need help designing and implementing the new decision-making systems that family, board and management will need to steward the business after the founder is gone.

Decision-making challenges

The following examples point out just a few of the decision-making challenges that can arise from estate planning transactions:

- *Who's the Leader?* Most estate plans sprinkle ownership among a group of diverse family members, oftentimes in trust. As a result, ownership power that was originally held by a single individual (the founder) may now be held by a group of individuals and entities. Questions will naturally arise: What powers will the owners (or trustees) exercise? If the new CEO is a family member, will he assume he's stepping into the shoes of the founder and has all the same powers that the founder had? At the same time, will the non-managing owners and directors feel that they instead should hold much of the power that the founder held? Who's right? The estate planning

documents typically won't resolve this issue. However, a business advisor, who understands enterprise governance and collaborates in the estate planning process, can add immense value to help clarify and articulate a new balance of power.

- *That's Not Fair!* Often, the demise of the founder creates a power vacuum that stokes discontent and animosity among family members. The estate plan may spell out who gets what, but it rarely explains why. Parents assume their motives are transparent and that their children will understand that they acted out of love, but children don't always see it that way. An advisor who specializes in family dynamics and relationships can help the founder and spouse clarify their intentions before beginning the estate planning process, and can also help family members sort through the emotions and work together constructively after the founder's passing. Creating a forum for family members to come together – a family assembly – can provide a place for family discussions that might otherwise flare up in the office.
- *Outside, Looking In:* When the family business is transferred in trust, the biggest challenge for the next generation of owners is that the trust distances the beneficiaries from the business. This alienation can be unintentionally enhanced by choosing the wrong trustee.

Careful attention needs to be paid to family frictions that can be ignited when clients carelessly nominate trustees within wills and family trusts, when these same trustees occupy board of director positions of the family enterprises that comprise, in whole or part, the corpus of the trust. Most clients know intuitively that trustees must act solely in the interests of all trust beneficiaries. It goes without saying that a trustee cannot transact business with trust property for any personal benefit. In family enterprises where there may not be that many trusted advisors who are willing or able to serve as a fiduciary, it is tempting to simply default to a director who is also a family member, to serve as a trustee. After all, that individual knows the most about the business and the family, right?

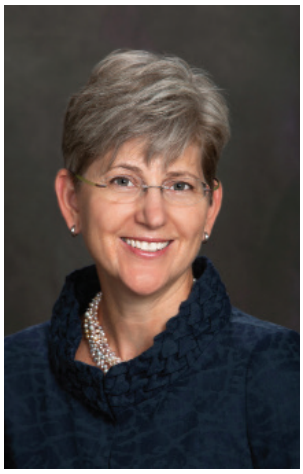
But query if it is prudent to name the same person as trustee and director. Directors owe fiduciary duties of loyalty and impartiality to the shareholders and the business; trustees owe fiduciary duties to the beneficiaries. Without a basic system of checks and balances, the appointment of an individual who is also a director or CEO as trustee of a trust that owns or operates a family business can easily put that individual in an impossible situation or a conflicting position.

It is not hard to imagine situations arising where the course of action that is best for the business may not be best for a beneficiary of the trust. What then? How will the family member holding multiple titles balance these duties? Spending time developing a roster of knowledgeable, capable individuals to serve so that no single individual must occupy more than one role; building governance mechanisms into the trust agreement, training trustees and directors to recognize situations where conflict is possible; and developing effective communication and decision-making between board and owners – all can improve decision-making and also reduce the risk of a family member getting caught in the web of conflicting duties.

In the same vein, it is important to note that multiple duties don't automatically imply a conflict of interest. Rather, it is the person's actions themselves in the dual capacity that may be harmful to other family members; thus creating a conflict of interest for the entire family to ponder and plan around.

- *Beneficiaries left out.* It should come as no surprise that beneficiaries may come to feel that they have no role, and their interest in the business turns to apathy or even anger. A beneficiary who lacks any control over the business is far more likely to seek an exit than a beneficiary who is engaged in the business in some fashion. If the founder's desire in setting up the trust is purely tax-driven, and the founder wants the beneficiaries to have a say in enterprise decision-making – in other words, if the founder would have given the shares outright but for taxes–then the trust instrument must allow and encourage the trustee to seek the beneficiaries' input on shareholder decisions. An advisor who understands fiduciary as well as business systems can help the founder, trustee and beneficiaries develop effective governance at the trust level that aligns with the business and family governance.

Estate planning is intended to prevent a number of undeniably bad outcomes at a critical moment in time – a large tax bill or a claim by an angry creditor, such as a divorcing spouse. By contrast, the human and financial consequences of estate planning transfers of control will linger over decades and generations. Succession planning for family businesses needs to be turned right side out. When there is a team of skilled advisors working alongside the estate planner and founder who can help the family think more deeply about the future of the family and the business, the odds of long term success will increase exponentially.



Amelia Renkert-Thomas, of New Haven, CT, is the US-based joint managing director of Withers Consulting Group. She previously founded Fisher Renkert Consulting LLC, a family enterprise consulting firm focusing on governance architecture and family enterprise succession planning, and co-founded FBS Global Limited, an international consulting think-tank with a multi-disciplinary approach to advising family enterprises and entrepreneurs, serving affiliates throughout the US and Europe. Prior to developing her consulting practice, Amy was a Partner at the international law firm Withers Bergman LLP, where she co-chaired the firm's Family Office Group. She ran her family's 5th generation manufacturing company from 1990-2002 and currently serves as an officer and director. Amy received her B.A. from Yale College, her J.D. from Harvard Law School, and her L.L.M in Taxation from the Case Western Reserve University School of Law.

Withers Consulting Group works with family businesses to help them define their vision of success, and then put a plan in place to achieve it. The firm specializes in governance design and succession planning to help families navigate inter-generational transitions.

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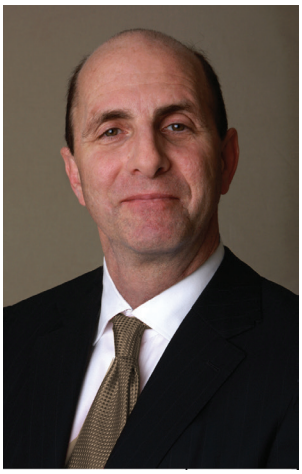

Roy P. Kozupsky is a partner and the head of the Trusts & Estates department in the New York City offices of Smith, Gambrell & Russell, LLP. Since being admitted to practice in 1985, Mr. Kozupsky has worked exclusively as a trusts & estate practitioner. His work encompasses strategic governance planning for large families and their business enterprises and the private wealth planning for these clients and their extended families in the following areas:

1. *Intergenerational wealth transfer planning for families and business owners,*
2. *Philanthropic planning,*
3. *Estate, Trust and fiduciary litigation*

A significant component to Mr. Kozupsky's practice is family legacy planning for families whose wealth is aligned with their family businesses and provides for strategic planning, consulting and administration for wealth creators and their families.

This area of legacy planning for large and complex families and their family enterprises is achieved through extensive collaborative work with other non-lawyer professionals who specialize in family business planning. Mr. Kozupsky received his B.A. degree from University of Colorado in 1978. In 1985, he received his J.D. degree from the David A. Clarke School of Law. He is a member of the State Bar of New York. Mr. Kozupsky is a proud member of AFHE - Attorneys for Family Held Enterprises and Family Firm Institute.