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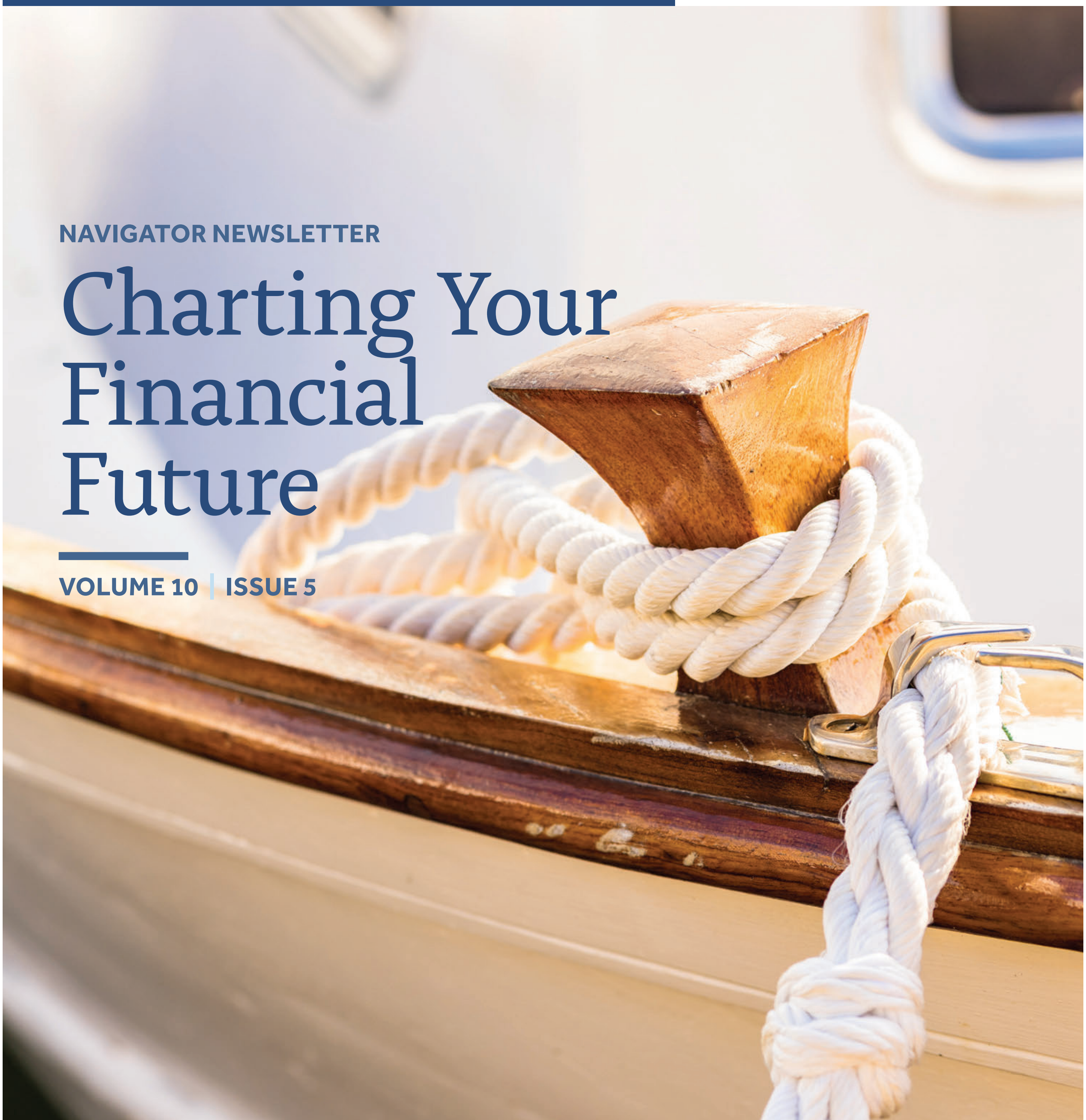

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Planning for business succession is key differentiator for astute entrepreneurs.

By David R. Toups, JD, MBA, CFA®, CFP®, CTFA

Many an entrepreneur has worked hard to build a successful, thriving business; however, only a rare few actively create an exit strategy or contingent planning structures for inevitable life events that will ultimately occur. As a result, the entrepreneur's family often suffers greatly if an unfortunate life event befalls him or her, and the business folds or is liquidated at a small fraction of its previous valuation. Business succession planning should be an integral part of every business that has made it past its fledgling infancy stages and has grown into a viable, going concern.

An entrepreneur who creates and runs the day-to-day operations of his or her business is the foremost expert in the world on how and what is necessary to keep the business operating and viable. These critical components need to be identified and contractual agreements should be created and implemented directing what is to occur in the event of the entrepreneur's death, incapacity, or prolonged absence. Unless the entrepreneur expends the time and effort to provide for these documents, someone less knowledgeable or completely ignorant of these critical components could make less than optimal decisions for the entity's future, resulting in a decreased or greatly diminished financial result. For entrepreneurs without partners or key personnel, these planning documents are vital to the continued operation and functionality of the entity.

For entrepreneurs with business partners or key personnel, business succession documents should identify and describe critical proxies or mechanisms for an accurate determination of fair market value for the business. Without this key variable, family members or personal representatives may be placed at a severe information disadvantage in valuation negotiations for that entrepreneur's interest in the firm. To make sure an entrepreneur's family benefits from the years of hard work he or she invested in building the business, the business succession plan should provide timelines, valuation procedures, and clearly defined acquisition processes so all parties know exactly what to expect in the event of each different type of life contingency.

In the event the business is owned or could eventually be owned by a non-person entity such as a trust, partnership, corporation, or limited liability company, the business succession plan also should address contingencies that may befall owners such as these. Non-person entities may dissolve, become insolvent, declare bankruptcy, be acquired, or have an internal management or ownership change. If a business's succession planning documents do not address such contingencies, the owners may have to endure an adversarial co-owner that otherwise could have been avoided or stopped with a well-drafted business succession plan that provided purchase options triggered by such contingencies.

If the entrepreneur is married or may be married, the business succession documents should specifically address marital discord contingencies for owners. Courts exercising jurisdiction over marital assets often have wide discretion in the division and distribution of owned business interests. Also, state law may provide statutory rights to spouses that may wreak havoc with the ownership continuity of a closely held business. If binding business succession agreements exist regarding the division and disposition of these assets prior to the contingency, the latitude provided the court and the effect of spousal statutory rights may be substantially curtailed.

Another key component of a cohesive business succession plan is a funding mechanism for the acquisition of a departing entrepreneur's interest. Some business succession plans utilize medium to long-term promissory notes to fund the acquisition of a departing owner's interest; however, if the cash flow of the business is only marginally sufficient to meet operations, an economic downturn or unfortunate turn of events may cause a default on the note with little to no recourse on the default.

After successfully running the gauntlet of adverse life events, some entrepreneurs eventually seek to retire; however, unless an exit strategy has been developed and implemented, a sale or acquisition may not be readily available or may face unfavorable tax treatment. Many times, after having a front-row seat while growing up and observing the exhausting hard work expended in creating the business, the children of a successful business owner want nothing to do with it and pursue other career paths. However, for those owners who plan ahead, suitable apprentice-type successors may be sought and integrated into the business, allowing the owner to retire and obtain optimal value for the company he or she created. Additionally, a negotiated and well-contemplated ownership transition provides for proper structuring to mitigate the effects of taxation, and contractual protections to minimize default risks to each party.

Many business owners fall into the trap of diligently focusing on the urgent short-term operational demands of the business, all the

while putting off or neglecting the important directional and protective planning critical to its ultimate longevity and long-term value extraction. Trusted advisors familiar with business succession planning are a great resource and can substantially aid in clarifying and creating plans to avoid such pitfalls. After working so hard to create, nurture, and build a successful business, such planning truly distinguishes the most astute entrepreneurs.

David R. Toups, JD, MBA, CFA®, CFP®, CTFA, joined The Nautilus Group in 2016 after more than 14 years in the private practice of law focused in estate, trust, guardianship, and business planning and litigation. Prior to practicing law, he managed money professionally as an investment portfolio manager for several national corporate fiduciaries. He earned his BBA in marketing from Texas A&M; his MBA, with a finance emphasis, from Sam Houston State; and his JD, with honors, from South Texas College of Law. David is a former U.S. Marine Corps artillery and infantry officer.

Strategies for IRA distributions following enactment of the SECURE Act.

By Robert S. Keebler, CPA/PFS, MST, AEP® (Distinguished)

One of the key changes made by the SECURE Act is a new 10-year rule for distributions from most non-spousal inherited IRAs.[1] All distributions from these accounts must now be distributed to beneficiaries within 10 years after the IRA owner dies. This eliminates the "stretch IRA" which allowed non-spousal beneficiaries to stretch out distributions over their lifetimes. A young beneficiary could be named, allowing the account assets to grow at their pre-tax rate of return for a long period of time. For beneficiaries who didn't need the money, stretch IRAs could be used as an inheritance vehicle to accumulate large amounts for future generations of the family.

This review of suggested strategies that owners of large IRAs might use to maximize the wealth that can be accumulated from their IRAs for their families following enactment of the SECURE Act looks at:

1. Charitable remainder trusts,
2. Multi-generational accumulation trusts,
3. IRC Section 678 trusts,
4. Incomplete gift non-grantor trusts,
5. Life insurance, and
6. Roth IRA conversions.

Charitable Remainder Trust as IRA Beneficiary

The stretch IRA was the ideal method for maximizing the time during which IRA assets could grow tax-free for non-spouse beneficiaries. Although the SECURE Act eliminated this strategy, its long tax deferral period can still be replicated to a large extent by transferring IRA assets to a charitable remainder trust (CRAT or CRUT).

Spreading out distributions

If a charitable remainder trust (CRT) is named the beneficiary of a traditional IRA, there is no tax when the funds in the IRA are distributed to the trust.

Tax is only payable when the beneficiaries receive distributions from the CRT. These distributions can be spread out over a term of years not to exceed 20, or for the life or lives of a named individual or individuals, creating a long deferral period.

1 An exception is made for "eligible designated beneficiaries." These include beneficiaries who are disabled, chronically ill, or less than 10 years younger than the IRA owner and minor children of an IRA owner.

Charitable intent

Internal Revenue Code Sections 664(d)(1)(D) and 664(d)(2)(D) require that the present value of the charitable remainder interest must be at least 10% of the initial value of the trust assets. Thus, charitable intent might be necessary to make this strategy work.

Multi-generational Accumulation Trusts

If an accumulation trust is named the beneficiary of an IRA, all the IRA funds would have to be paid to the trust by the end of the 10-year period, but the trustee would have the discretion to decide how much, if any, to pay to the beneficiaries and how much to keep in the trust.

Although accumulation trusts increase costs and add complexity, they also create important non-tax advantages for a family. They limit beneficiary access to funds, protect assets from creditors, provide professional management of trust assets, and may enable the trustee to manage tax brackets. They also may provide divorce protection and dead-hand control and facilitate estate planning and planning for beneficiaries with special needs.

The trust would be structured as a spray trust, naming a broad group of family members as beneficiaries and spraying distributions across the group according to instructions provided by the grantor to the trustee. These beneficiaries could include more than one generation of the IRA owner's family. This would give the family the flexibility to vary the amount of income in respect of a decedent (IRD) distributed to minimize income tax obligations. Thus, a spray trust could be used to combine the tax benefits of low tax rates with the non-tax advantages of an accumulation trust.

IRC Section 678 Trust

As noted above, accumulation trusts can provide important non-tax benefits for a family. To get these advantages, however, the assets must stay in the trust instead of being distributed to the trust beneficiaries. Unfortunately, any amounts retained in the trusts would ordinarily be taxed at the high trust tax rates. For 2020, all trust income above $12,950 is taxed at the top individual income tax rate of 37%. By contrast, if the required minimum distributions (RMDs) are distributed to the trust beneficiaries, they will be taxed at the beneficiaries' individual tax rates, which might be substantially lower.

Under IRC Section 678, a person other than the trust's grantor is treated as the owner of a trust if that person is given a power to withdraw trust assets without the consent of any other person. If a trust beneficiary is treated as the owner of a trust under Section 678, all items of income, deductions, and credits against tax of the trust would be reported on the beneficiary's Form 1040 instead of on the trust's tax return. This would enable the trust to retain and accumulate the RMDs in the trust without paying the high trust rates. The family of the IRA owner would get the best of both worlds, the advantages of leaving the assets in the trust with the lower tax rates of the individual beneficiaries.

Incomplete Gift Non-Grantor (ING) Trusts

The benefits of using an accumulation trust as a beneficiary of an IRA can be enhanced by making the trust an incomplete gift non-grantor trust in a state that doesn't tax trust income. The leading states for creating these ING trusts are Delaware, Nevada and Wyoming. They also can be created in several other states.

Life Insurance

Beneficiaries who don't need the required minimum distributions they receive from their inherited IRAs during the 10-year SECURE Act period may be able to increase the amounts that can be accumulated for heirs by using some or all of the distributions they receive from the IRA to buy life insurance, provided they have an insurable need. The proceeds of the policy would be paid income tax-free to the beneficiary's heirs or to a trust for their benefit.

Life insurance has two advantages: First, assuming that the contract meets the definition of life insurance, there is no tax on the build-up of the policy's cash surrender value. Moreover, there is generally no income tax payable when the insured dies. Thus, as a general rule, the insurance proceeds are never subject to income tax.

Key factors when considering whether life insurance is a favorable strategy include tax deferrals and longevity of the insured.

Roth IRA Conversions

An important advantage of a Roth IRA is that there are no RMDs. This enables the entire value of the IRA to grow tax-free until the beneficiary's death, facilitating accumulation of wealth for the family.

If the beneficiary doesn't need distributions, the Roth IRA could be viewed more as a wealth transfer tool than as a retirement income vehicle.

Roth IRA conversion vs. other strategies

An advantage of a Roth conversion over a transfer to a CRT is that there is no need to transfer 10% of the value to charity. The full value can go to heirs.

The advantage of transferring the IRA assets to an irrevocable non-grantor trust would be that distributions to beneficiaries could be spread out and state income tax could be avoided. The Roth IRA could not only avoid state income tax, but also federal income tax.

Conclusion

There are many strategies to consider when it comes to IRA distributions.

Unique personal and financial objectives must be considered in light of ever-changing legislation. Individuals are urged to consult with financial professionals who can provide the expertise necessary to help them choose the best course to navigate this complex arena.

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Six things you may not know about state estate taxes.

By Eva Stark, JD, LL.M.

1 You may live in a state with a state estate tax and/or inheritance tax regime.

Seventeen states and the District of Columbia currently impose some type of state-level estate tax or inheritance tax.[1] To many individuals, the terms "estate tax" and "inheritance tax" may seem interchangeable as they both imply a death-related tax. However, a true estate tax is a tax on the right to pass property onto others and is usually payable by the decedent's estate. A true inheritance tax, in contrast, is a tax on a beneficiary's right to receive property and is usually imposed on the beneficiary.

Another key distinction between the two taxes is that the estate tax rate is generally the same regardless of who the recipient of the property may be. An inheritance tax rate tends to vary depending on the relation of the beneficiary to the decedent. Generally, transfers to "close relatives" such as children may escape inheritance taxes or are taxed at a preferential rate, while transfers to more "distant" relatives such as nieces and nephews or cousins may be subject to higher rates.

2 You may be subject to state estate taxes even if you do not live in a state with a state estate tax regime.

In addition to imposing an estate tax on decedents domiciled[2] in the state, states with an estate tax regime may impose an estate tax on the real property or tangible property of "nonresidents" that is physically in the state. Other property with a connection to the state may be subject to state death taxes as well. For example, a state's estate tax laws may tax certain interests in entities which own realty in the state, interests in certain entities taxed as partnerships or S corporations that own closely held businesses or farms in the state, etc.—specific state law provisions regarding what may be taxable vary widely.

In addition to the surprise tax-hit, nonresidents may only qualify for a reduced estate tax exemption amount as compared to residents of the state.

3 Your state estate tax exemption may be lower than the federal exemption.

While federal estate taxes affect only a small group of taxpayers, state estate taxes have significantly lower exemptions and are a concern for a much wider range of individuals. The Tax Cuts and Jobs Act of 2017 doubled the federal estate tax exemption amount to $10 million. Adjusted for inflation, the exemption amount in 2020 is $11.58 million per spouse.[3] In contrast, state estate tax exemption amounts can be as low as $1 million in Massachusetts or Oregon, $2,193,000 in Washington, $3 million in Minnesota or $4 million in Illinois. While some states have indexed their estate tax exemption for inflation, others have not.

1 CT, HI, IL, ME, MD, MA, MN, NY, OR, RI, VT, WA and the District of Columbia impose an estate tax. IA, KY, MD and PA impose an inheritance tax, and NE imposes a county inheritance tax. MD imposes both an estate tax and an inheritance tax.

2 An individual's domicile, not residency, generally determines whether the individual will be taxed as a "resident" or "nonresident" for state estate tax purposes. Domicile generally refers to the place an individual views as his or her permanent home.

3 Certain provisions of the Tax Cuts and Jobs Act of 2017 are scheduled to sunset at the end of 2025 and the federal estate tax exemption amount will be reduced to $5 million, adjusted for inflation.

4 Your state estate tax rate may be lower than the federal rate.

The highest marginal federal estate tax rate is 40%, applicable to taxable amounts in excess of $1 million. State estate tax rates are typically much lower. The highest marginal state estate tax rate may be in the 16% to 20% range, or lower, depending on the state. While not all states offer graduated rates, the highest tax bracket is often not reached until taxable amounts exceed $9-$10 million.

5 Your state estate tax exemption may not be portable, which may necessitate additional planning.

The federal estate tax exemption is "portable"—i.e., a decedent's unused federal estate tax exemption may be utilized by the surviving spouse in certain circumstances. If the decedent passes $1 million to his children upon death and all other assets pass to the surviving spouse, the surviving spouse might be able to utilize the decedent's remaining $10.48 million exemption in addition to his or her own exemption. Portability may allow a surviving spouse to take advantage of his/her deceased spouse's unused exemption without traditional "A-B" trust planning.

A-B trust planning involves the creation and funding of a "bypass trust" at the first death to utilize the decedent's exemption and channeling remaining assets to the survivor to defer estate taxes until the second death.

Many states that impose a state estate tax do not currently allow for portability of an individual's state estate tax exemption amount. As a result, a bypass trust may be required to utilize the predeceased spouse's state exemption amount, or it may be wasted and the family's state estate taxes will unnecessarily increase at the survivor's death. In some states, it may also be permissible to create a separate "state QTIP trust" which may defer state estate taxes until the surviving spouse's death and also utilize the decedent's exemption for federal estate tax purposes. (Note that some states do not permit a separate state-QTIP election).

6 Your state may not have a gift tax—even if it has an estate tax.

For federal tax purposes, the gift and estate tax exemptions have been unified—with a combined lifetime exemption of $11.58 million (in 2020). Lifetime gifts that utilize the exemption reduce the amount of exemption that remains available at death. This may not be the case with state estate taxes.[4] In several—but not all—states with a state estate or inheritance tax regime, it may be possible to reduce or avoid state estate or inheritance tax by making lifetime gifts. Those contemplating lifetime gifts should be mindful that rules may be in place that penalize the use of "deathbed" gifts to avoid the estate or inheritance tax and a look-back period may apply. Additionally, certain states may take into account lifetime gifts for filing thresholds for estate taxes.

State estate, inheritance and gift tax laws vary greatly from state to state and change frequently. As such, clients should always consult with a CPA, tax attorney or estate planning attorney regarding specific state death taxes that may be applicable to them and state estate, gift or inheritance tax planning.

4 CT has a unified gift and estate tax regime.

Eva Stark, JD, LL.M., joined The Nautilus Group in 2014 to assist with the development of estate and business plans. She also performs advanced tax research. Eva graduated summa cum laude with a BS in economics and finance from The University of Texas at Dallas. She earned her JD, with honors, from Southern Methodist University, where she served as a student attorney and chief counsel at the SMU Federal Taxpayers Clinic. She received her LL.M. in taxation from Georgetown University Law Center. Prior to joining Nautilus, Eva worked in private practice in tax controversy, business law, and litigation.