THE ESTATE PLANNER

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KEEPING THE FAMILY BUSINESS IN THE FAMILY

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Keeping the family business in the family

Transferring a family business to the next generation requires a delicate balancing act. Estate and succession planning strategies aren't always compatible, and the older and younger generations often have conflicting interests. By starting early and planning carefully, however, it's possible to resolve these conflicts and transfer the business in a tax-efficient manner.

Ownership vs. management succession

One reason transferring a family business is such a challenge is the distinction between ownership and management succession. When a business is sold to a third party, ownership and management succession typically occur simultaneously. But in the family business context, there may be reasons to separate the two.

From an estate planning perspective, transferring assets to the younger generation as early as possible allows you to remove future appreciation from your estate, minimizing estate taxes. On the other hand, you may not be ready to hand over the reins of your business or you may feel that your children aren't yet ready to take over.

There are several strategies owners can use to transfer ownership without immediately giving up control, including:

- Placing business interests in a trust, family limited partnership (FLP) or other vehicle that allows the owner to transfer substantial ownership interests to the younger generation while retaining management control,
- Transferring ownership to the next generation in the form of nonvoting stock, or
- Establishing an employee stock ownership plan. (See "Using an ESOP as an exit strategy" on page 3.)

Another reason to separate ownership and management succession is to deal with family members who aren't involved in the business. It's not unusual for a family business owner to have substantially all of his or her wealth tied up in the business. Providing heirs outside the business with nonvoting stock or other equity interests that don't confer control can be an effective way to share the wealth while allowing those who work in the business to take over management.

Another strategy is to purchase life insurance to create liquidity for family members not involved in the business.

Conflicting financial needs

Another unique challenge presented by family businesses is that the older and younger generations may have conflicting financial needs. For example, a business owner may be relying on the value of the business to fund his or her retirement, while his or her children might hope to acquire the business without a significant investment on their part.

Fortunately, several strategies are available to generate cash flow for the owner while minimizing the burden on the next generation. They include:

An installment sale of the business to children or other family members. This provides liquidity for the owners while easing the burden on the younger

generation and improving the chances that the purchase can be funded by cash flows from the business. Plus, so long as the price and terms are comparable to arm's-length transactions between unrelated parties, the sale shouldn't trigger gift or estate taxes.

A grantor retained annuity trust (GRAT). By transferring business interests to a GRAT, owners obtain a variety of gift and estate tax benefits (provided they survive the trust term) while enjoying a fixed income stream for a period of years. At the end of the term, the business is transferred to the owners' children or other beneficiaries. GRATs are typically designed to be gift-tax-free.

An installment sale to an intentionally defective grantor trust (IDGT). This is a somewhat complex transaction, but essentially a properly structured IDGT allows an owner to sell the business on a tax-advantaged basis while enjoying an income stream and retaining control during the trust term. Once the installment payments are complete, the business passes to the owner's beneficiaries free of gift taxes.

Because each family business is different, it's important to work with your estate planning advisor to identify appropriate strategies in light of your objectives and resources.

Get an early start

Another consideration is that it's possible the federal gift and estate tax might be repealed sometime this year. (Check with your estate planning advisor for the latest information.) That could impact which strategy is best for you.

But regardless of your strategy, the earlier you start planning the better. Transitioning the business gradually over several years or even a decade or more gives you time to educate family members about your succession planning philosophy, to relinquish control over time, and to implement tax-efficient business structures and transfer strategies.

Starting early will also give your children time to obtain the training and experience they need to successfully manage the business. In addition, if the transition will involve a sale of the business to the younger generation, an early start gives them time to put together the necessary funds and increases the chances that the purchase can be financed by cash flow from the business. ▮

Using an ESOP as an exit strategy

For family business owners who lack liquid assets outside the business, an employee stock ownership plan (ESOP) can provide an effective exit strategy. An ESOP is a qualified retirement plan that's similar to a 401(k) plan but invests primarily in your company's stock.

For owners who sell their shares to an ESOP, it provides a tax-advantaged vehicle for transferring stock to family members who work in the business and other employees, while allowing the owners to cash out some of their equity in the business. Owners can use this newfound liquidity to fund their retirements, diversify their portfolios or provide for family members who aren't involved in the business. Plus, if the ESOP is structured properly, the owners can maintain control over the business for an extended period of time even if the ESOP acquires a majority of the company's stock.

In addition, if certain requirements are met, the owners can defer capital gains taxes on the sale of their stock by reinvesting some or all of the proceeds in "qualified replacement property" (including most publicly traded securities).

Keep in mind that as of this writing there is a lot of discussion about potential tax law changes in 2017. Thus, it's prudent to get the latest about any proposed or pending ESOP-related discussions in Congress.

Don't overlook securities laws when planning your estate

For a variety of estate planning and asset management purposes, many affluent families hold their assets in trusts, family investment vehicles — such as family limited partnerships (FLPs) and family limited liability companies (FLLCs) — or in charitable foundations. If assets held in this manner include interests in hedge funds, private equity funds or other "unregistered" securities, it's important to ensure that the entity is qualified to hold such investments.

Certain exemptions under the federal securities laws require that investors in private funds and other unregistered securities qualify as "accredited investors" or "qualified purchasers." Let's take a closer look at the criteria for determining whether a family entity is an accredited investor or a qualified purchaser. Keep in mind that there's a lot of nuance in the definitions. The information provided is intended to be a guideline — your specific circumstances could vary from the general rules.

Individuals are qualified purchasers if they have at least $5 million in investments.

Why it matters

Generally, companies or funds that offer securities for sale are subject to burdensome (and costly) registration and reporting requirements under the Securities Act of 1933, unless they fall within one of several exemptions. Perhaps the most common exemption is Rule 506(b) of Regulation D, which exempts sales of securities to an unlimited number of accredited investors plus up to 35 nonaccredited, "sophisticated" investors.

Private investment funds also typically rely on two exemptions from registration under the Investment Company Act of 1940. These exemptions allow a fund to avoid registration if 1) it limits the fund to no more than 100 investors, or 2), if there are more than 100 investors, it allows only qualified purchasers to invest.

What is an accredited investor?

Accredited investors include financial institutions and other entities that meet certain requirements, as well as certain officers, directors and other insiders of the entity whose securities are being offered. They also include individuals with either 1) a net worth of at least $1 million (excluding their primary residence), or 2) income of at least $200,000 ($300,000 for married couples) in each of the preceding two years, and with a reasonable expectation of meeting the requirements in the current year.

A trust (including a foundation organized as a trust) can qualify as an accredited investor in one of three ways:

1. Its assets are greater than $5 million, it wasn't formed for the specific purpose of acquiring the securities in question and a sophisticated person directs its investments.
2. A national bank or other qualifying financial institution serves as trustee.
3. The trust is revocable and the grantor qualifies as an accredited investor individually.

Family investment vehicles are accredited investors if their assets exceed $5 million and they weren't

formed for the specific purpose of making the investment in question. Alternatively, they can qualify as accredited if all of their equity owners are accredited. Generally, a foundation not organized as a trust is accredited only if its assets exceed $5 million.

What is a qualified purchaser?

Individuals are qualified purchasers if they have at least $5 million in investments. Other qualified purchasers include:

- An entity that has at least $5 million in investments, with all of its beneficiaries being either closely related family members (siblings, current or former spouses, or direct lineal descendants); estates, foundations, or charitable organizations of such family members; or trusts created by or for the benefit of the family member described,
- A trust that doesn't meet the family exception above, so long as the trust wasn't established solely for the purpose of making the investment, and every individual associated with the trust as either creator, contributor or investment decision-maker is considered a qualified investor, or
- An entity with not less than $25 million in investments.

Avoid surprises

If your estate plan includes trusts, family investment vehicles or charitable foundations, it's important to determine early on whether they'll hold interests in hedge funds, private equity funds or other "alternative" investments. If they will, it's critical to structure these entities so that they qualify as accredited investors and qualified purchasers. Otherwise, you may discover that they're unable to invest their assets in the manner you intended. ▮

Home sweet vacation home

Minimize family strife with smart planning and rules

According to the National Association of Realtors' (NAR's) *2016 Investment and Vacation Home Buyers Survey*, 2015 had the second highest number of vacation home sales (920,000) in nearly a decade. (The NAR said 2014 had the highest number at 1.13 million.)

If your family owns a vacation home, you know what a relaxing refuge it can be. However, without a solid plan and ground rules that all family members agree to, conflict and tension may result in a ruined vacation — or worse yet, selling the home.

Determining ownership

It may seem obvious, but it's important for all family members to understand who actually owns the home. Family members sharing the home will more readily accept decisions about its usage or

disposition knowing that they come from those holding legal title.

If the home has multiple owners — several siblings, for example — consider the form of ownership carefully. There may be advantages to holding title to the home in a family limited partnership (FLP) or family limited liability company (FLLC) and using FLP or FLLC interests to allocate ownership interests among family members. You can even design the partnership or operating agreement — or a separate buy-sell agreement — to help keep the home in the family.

Laying down the rules

Typically, disputes between family members arise because of conflicting assumptions about how and when the home may be used, who's responsible for cleaning and upkeep, and the ultimate disposition of the property. To avoid these disputes, it's important to agree on a clear set of rules that cover using the home (when, by whom); inviting guests; responsibilities for cleaning, maintenance and repairs; acceptable activities, behavior and noise levels; and dealing with emergencies or unexpected events.

If you plan to rent out the home as a source of income, it's critical to establish rules for such rental activities. The tax implications of renting out a vacation home depend on several factors, including the number of rental days and the amount of personal use during the year.

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Planning for the future

What happens if an owner dies, divorces or decides to sell his or her interest in the home? It depends on who owns the home and how the legal title is held. If the home is owned by a married couple or an individual, the disposition of the home upon death or divorce will be dictated by the relevant estate plan or divorce settlement.

If family members own the home as tenants-in-common, they're generally free to sell their interests to whomever they choose, to bequeath their interests to their heirs or to force a sale of the entire property under certain circumstances. If they hold the property as joint tenants with rights of survivorship, an owner's interest automatically passes to the surviving owners at death. If the home is held in an FLP or FLLC, family members have a great deal of flexibility to determine what happens to an owner's interest in the event of death, divorce or sale.

Keeping it in the family

If your vacation home has been in your family for generations, you'll want to do everything possible to hold on to it for future generations. We can assist you in developing a plan to help you achieve this. ▮

ESTATE PLANNING RED FLAG

You missed the 60-day IRA rollover deadline

IRAs and employer plans are powerful retirement savings tools, but they also provide valuable estate planning benefits. If you hold an IRA for life, for example, your children or other heirs can stretch out distributions over their lifetimes, maximizing the IRA's tax-deferred growth and preserving more wealth for your loved ones. If you receive a distribution from an IRA or employer plan, you can preserve these benefits by rolling over the funds into a new IRA or plan within 60 days.

But what happens if you miss the 60-day deadline? You'll be hit with ordinary income taxes plus a 10% penalty (if you're under age 59½), taking a significant bite out of your estate.

The IRS has provided some relief by streamlining procedures for obtaining a waiver of the 60-day time limit. Previously, the only option was to apply to the IRS for a private letter ruling — a costly and time-consuming process. Now, if you miss the deadline, you can self-certify your eligibility for a waiver by sending a letter to the trustee or administrator of the IRA or plan.

To qualify, you must have missed the deadline for one of 11 listed reasons. They include errors by the financial institution distributing or receiving the funds, misplaced distribution checks, post office errors, a death or serious illness in the family, and deposits into an account you mistakenly thought was an eligible retirement plan.

You must complete the rollover "as soon as practicable" (30 days is deemed sufficient) after the reasons for missing the deadline are no longer an obstacle. Even if you can't (or don't) self-certify, the IRS can still grant a waiver for these or other reasons in a subsequent examination.

Self-certification allows you to report a deposit as a valid rollover. But it doesn't prevent the IRS from auditing your return and denying a waiver if it determines that you didn't meet the requirements.

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