McNEES INSIGHTS
ESTATE PLANNING

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TRANSITIONING THE FAMILY BUSINESS TO THE NEXT GENERATION

by Vance E. Antonacci

The transition of a family owned business involves a variety of legal and tax issues. While most business owners plan to avoid taxes and develop creditor protection strategies, business owners also should be focused on preserving family harmony, furthering family values, and ensuring that future generations have the skills needed to be successful. The timing of a plan, establishing goals, and determining values must be incorporated for a plan to be successful.

Goal Setting and Communication

Family discussions about succession planning are difficult. Various issues must be discussed - finances, mortality, children in the business, children not in the business, who will take over in management – and discussing these issues is not easy. Nonetheless, a succession plan has little chance of working if there is a lack of substantive discussion of these important issues.

The first step is for the family business owner to set clear goals and objectives and to establish time frames for achieving them. Among other things, the business owner should establish in writing:

- A set of values that family members are expected to follow
- A set of rules for the hiring, compensation, and promotion of family members
- A policy on distributions from the business and the transfer of ownership interests
- A policy for conflict resolution

The values, goals, and objectives of a succession plan are often set forth in a "family constitution." The purpose of a family constitution is to consolidate values, goals, and objectives into one document to help guide the family. In addition, the development of the family constitution often is a tool to teach family members the owner's values and objectives and to ensure that intra-family communication occurs in a productive, respectful, and thoughtful manner.

Timing is Everything

An often repeated phrase used in succession planning is that a business owner "cannot start too early." Some of the important issues that typically require long-term planning are identifying managers who can succeed the owner and setting rules for the involvement of family members in the business.

The transition of ownership and management of a business are not necessarily the same thing. Succession plans are structured to transfer ownership tax-efficiently between generations of a family. The identity of the managers of the business will change over time and these managers may or may not be family members. The current owner or group of owners must identify the best managers to take over executive level responsibilities and not focus on the family member who will be the best manager. Many situations exist where members of the next generation who are employed in the family business are not best suited to manage the business. It is critical that the best manager – and not the best manager who happens to be a family member – be elevated. Family members may be suited for specific responsibilities, such as finance, sales, or operations, but may not be suited for senior executive positions.

In addition, it is important at an early stage to establish policies relating to the employment of family members and ownership by them. Clear, written rules setting forth what is expected of employed family members and of owners should avoid intra-family conflict and tension with non-family members employed by the business.

Financial Planning

Many estate planning techniques involved in succession planning involve the owner divesting himself or herself of assets, such as limited partnership interests or non-voting stock. An important (but often overlooked) part of any succession plan is ensuring that the owner who is transitioning ownership has financial security. The transitioning owner needs to properly compensate other owners and executives, particularly when those individuals are assuming more responsibility. You cannot attract and retain talented individuals without compensating them fairly. However, few business owners are willing to transition ownership if there is an unreasonable risk of financial insecurity as a result. Therefore, it is important that the transitioning owner, in consultation with his or her financial advisors and accountant, maps out income needs and has a financial plan in place. For example, rent paid by the business to the owner can be an important piece to this puzzle. Consideration should also be given to fringe benefits, particularly health insurance. Transferring ownership, if done properly, does not have to result in a loss of financial security.

The "success" of a succession plan will be defined by the goals and objectives established at the outset of planning. As explained above, establishing goals and objectives in a timely manner is the foundation of any successful plan, and whether the goals and objectives are met should determine whether the plan was a success.

No two family businesses are alike. Each family and each family business will have its own set of challenges, goals, and values

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CHARITABLE TRUSTS AND ESTATE PLANNING *by Andrew S. Rusniak*

There are a number of ways in which clients can incorporate their desire to benefit charities into an estate plan. At the most basic level, the Internal Revenue Code (the "Code") generally provides for a federal estate tax charitable deduction for amounts passing to charities at death. However, one particularly powerful method of charitable giving is the incorporation of charitable trusts into an estate plan. Charitable trusts, also known as "split interest" trusts because they have both non-charitable and charitable beneficiaries, create a unique opportunity to ensure the financial stability of a client's surviving spouse or family while also entitling the client's estate to a charitable deduction. While there are many legitimate and useful reasons to create a charitable trust during life, this article will focus on the funding and use of charitable trusts at death.

In general, there are two main types of charitable trusts: the charitable remainder trust (the "CRT") and the charitable lead trust (the "CLT"). Both the CRT and the CLT are unique creatures of the Code and applicable Treasury Regulations that are strictly governed by certain prescribed qualifications. Charitable trusts should be distinguished from trusts that simply have a charity as either a current income beneficiary or a remainder beneficiary. Failure to strictly comply with the charitable trust rules can result in the loss of the trust's income tax exempt status as well as the loss of a charitable deduction.

Charitable Remainder Trusts

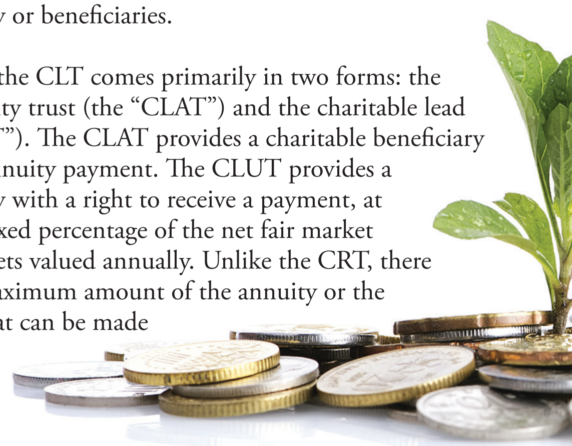
A testamentary CRT is a trust that is funded at death and that provides for the distribution of a specified amount, at least annually, to one or more non-charitable beneficiaries (such as a client's surviving spouse or family). The distributions must be for the life or lives of the non-charitable beneficiaries or for a term of years not to exceed twenty years. Once the non-charitable beneficiary's interest in the trust ends, the balance of the trust must then be held for the benefit of, or paid over to, one or more charities.

CRTs come primarily in two forms: the charitable remainder annuity trust (the "CRAT") and the charitable remainder unitrust (the "CRUT"). The distinction between the CRAT and the CRUT is in the annual distribution amount. The CRAT is a CRT that initially pays an annual annuity amount (a fixed dollar amount) to the non-charitable beneficiary, which amount must be a sum certain that is not less than 5% nor more than 50% of the initial net fair market value of the property placed in the trust. A CRUT is a CRT that initially pays an annual unitrust amount (a fixed percentage amount of the trust's net fair market value) to the non-charitable beneficiary. The unitrust amount must be between 5% and 50% of the net fair market value of the trust assets valued annually. The remainder interest (the amount passing to charity) must be at least 10% of the initial net fair market value of all property placed into the CRAT or CRUT.

Charitable Lead Trusts

A testamentary CLT is, in many ways, the opposite of the testamentary CRT. The testamentary CLT is a trust that is funded at death and that provides for the distribution of a specified amount, payable at least annually, to one or more charitable beneficiaries. The distributions may be made for a term of years or for the life or lives of an individual, each of whom must be living at the creation of the trust. Notably, however, unlike the CRT there is no limitation on the number of years that the annual distributions may be made to the charitable beneficiary or beneficiaries.

Similar to the CRT, the CLT comes primarily in two forms: the charitable lead annuity trust (the "CLAT") and the charitable lead unitrust (the "CLUT"). The CLAT provides a charitable beneficiary with a guaranteed annuity payment. The CLUT provides a charitable beneficiary with a right to receive a payment, at least annually, of a fixed percentage of the net fair market value of the trust assets valued annually. Unlike the CRT, there is no limit on the maximum amount of the annuity or the unitrust payment that can be made to the charitable beneficiary.



RECENT TAX DEVELOPMENTS *by David M. Watts*

The following is a summary of the most important tax developments that have occurred in the past several months that may affect you, your family, your investments, and your livelihood. Please call us for more information about any of these developments and what steps you should implement to take advantage of favorable developments and to minimize the impact of those that are unfavorable.

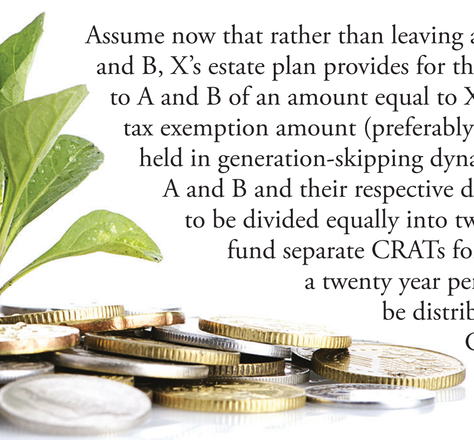
No bankruptcy exemption for inherited IRAs

A unanimous Supreme Court has held that inherited IRAs do not qualify for a bankruptcy exemption, i.e., they are not protected from creditors in bankruptcy. Under the Bankruptcy Code, a debtor may exempt amounts that are both (1) "retirement funds," and (2) exempt from income tax under one of several Internal Revenue Code provisions, including the one that provides a tax exemption for IRAs. Resolving a conflict between the Circuit Courts of Appeal, the Supreme Court has held that this exemption does not extend to inherited IRAs because funds held in them are not retirement funds. For this purpose, the term "inherited IRA" doesn't include amounts inherited by the spouse of the decedent. This decision should be taken into account when selecting IRA beneficiaries. If a potential beneficiary is under financial distress, the IRA owner should consider naming a trust as beneficiary instead. The individual could be named as beneficiary of the trust without jeopardizing the full IRA funds if he or she personally goes bankrupt.

Charitable Deduction

The foregoing rules illustrate the qualifications of a valid charitable trust. Once a testamentary CRAT or CRUT has been validly established, a client's estate becomes entitled to a charitable estate tax deduction equal to the actuarial value of the remainder interest passing to the charity. Once the testamentary CLAT or CLUT has been validly established, a client's estate becomes entitled to a charitable estate tax deduction equal to the actuarial value of the guaranteed annuity or unitrust interest. These calculations are designed to determine the present value of the amounts passing to charity. The values are not subsequently adjusted even if the value of the trust assets appreciates or depreciates significantly from the projected values. Thus, the charitable deduction is locked upon the creation of the charitable trust.

Example: Assume that X is charitably inclined and has a taxable estate of $12,000,000. Assume further that X has not utilized any of his $5,340,000 estate tax exemption amount. If X dies leaving all $12,000,000 to his two sons, A and B, X's estate would owe approximately $2,448,000 in federal estate tax and $540,000 in Pennsylvania inheritance tax. After the payment of death taxes, A and B would each receive approximately $4,506,000. Thus, approximately 25% of the X's estate will be lost to death taxes, and no portion of X's estate will be left to charity.



Assume now that rather than leaving all $12,000,000 outright to A and B, X's estate plan provides for the distribution in equal shares to A and B of an amount equal to X's remaining federal estate tax exemption amount (preferably these amounts would be held in generation-skipping dynasty trusts for the benefit of A and B and their respective descendants), with the balance to be divided equally into two shares. One share would fund separate CRATs for the benefit of A and B for a twenty year period, with the remainder to be distributed to X's favorite charity, C, and the other share would fund a single CLT that benefits C for a term of twenty years with the remainder to be distributed equally to A and B.

If we assume these shares are each $3,330,000 ($12,000,000 less $5,340,000 divided by 2), then the CRATs could pay out approximately $85,000 annually to A and B for twenty years. Assuming growth of 8% annually, the remainder of each CRAT would be almost $4,000,000. Thus, approximately $8,000,000 would be distributed to C when the trusts terminate. The CLAT for 20 years would distribute $165,000 annually to C. At the end of its twenty year term, the remainder, which would be almost $8,000,000 assuming 8% growth, would be distributed to A and B. Additionally, the combination of the CRATs and the CLAT would provide a charitable deduction against estate tax in the amount of $3,356,355, which would save almost $1,500,000 of estate tax and inheritance tax.

By incorporating charitable trusts in his estate plan, X is able to provide each of X's children with an initial distribution of $2,670,000, an income stream of approximately $85,000 for a term of 20 years, and a distribution of almost $4,000,000 after 20 years. Additionally, X is able to provide a significant benefit to his preferred charity, for which his estate is entitled to a charitable estate tax deduction.

Incorporating charitable trusts into an estate plan can be an excellent way for clients to ensure the financial stability of a client's surviving spouse or family while also entitling the client's estate to a charitable deduction. Although the requirements to establish a charitable trust can be very technical, and the consequences of failing to comply with the rules quite severe, there are many ways in which charitable trusts can be individually tailored to fit a variety of estate plans and can accomplish a wide range of objectives. ■

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Employer health insurance tactic may backfire

The IRS has warned of costly consequences to an employer that doesn't establish a health insurance plan for its employees, but reimburses them for premiums they pay for health insurance (either through a qualified health plan in the Marketplace or outside the Marketplace). According to the IRS, these arrangements, which are called employer payment plans, are considered to be group health plans subject to the market reforms of the Affordable Care Act. These reforms include the prohibition on annual limits for essential health benefits and the requirement to provide certain preventive care without cost sharing. Such arrangements cannot be integrated with individual policies to satisfy the market reforms. Consequently, such an arrangement fails to satisfy the market reforms and may be subject to a $100/day excise tax per applicable employee.

Qualified retirement plans and IRAs may permit purchases of "longevity" annuities

The IRS has issued regulations that allow purchases of deferred "longevity" annuities under various tax-favored retirement vehicles including 401(k) plans and IRAs. Under the regulations, retirees may use a limited portion of their retirement savings to purchase guaranteed income for life starting at an advanced age, such as 80 or 85, to address the risk of outliving their assets.

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and therefore each succession plan will take on a life of its own. Nevertheless, a family business succession plan has a better chance of succeeding if the plan is implemented in a timely manner with clear and realistic goals and objectives. ■

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RECENT TAX DEVELOPMENTS continued from page 3

More enforcement of responsible person penalty likely

If an employer fails to properly pay over its payroll taxes, the IRS can seek to collect a trust fund recovery penalty equal to 100% of the unpaid taxes from a person who is responsible for collecting and paying over payroll taxes and who willfully fails to do so. A recent report issued by the Treasury Inspector General for Tax Administration has found the IRS has often not taken adequate and timely actions in assessing and collecting the responsible person penalty. The report also makes recommendations for improvements. The IRS has agreed to implement the recommendations making greater enforcement of the penalty more likely.

Big tax for sellers who got home back from defaulting buyer

In a recent case, a married couple sold their home at a big gain for installment payments and a balloon payment down the road. In the process, they permissibly excluded $500,000 of their gain under the special exclusion for gain on sale of a principal residence. The buyers ultimately defaulted and the sellers got the home back. The IRS said that they had to report the previously excluded $500,000 gain on the reacquisition. The dispute wound up in the Tax Court, which sided with the IRS.

More trust/estate expenses escape deduction limit

Miscellaneous itemized deductions are allowed only to the extent they exceed 2% of adjusted gross income (AGI). For this purpose, the AGI of an estate or trust is computed the same way as for an individual, subject to certain exceptions. Under one exception, costs paid or incurred in connection with the administration of an estate or trust that wouldn't have been incurred if the property weren't held in the estate or trust are allowed as deductions in arriving at AGI. For a number of years, the IRS provided guidance on which costs qualified for the exception including proposed regulations issued in 2011. Recently, the IRS has issued final regulations, which list more trust/estate expenses that are deductible in computing an estate or trust's AGI than were included in the earlier guidance.

Next year's inflation adjustments for health savings accounts

The IRS has provided the annual inflation-adjusted contribution, deductible, and out-of-pocket expense limits for 2015 for health savings accounts (HSAs). Eligible individuals may, subject to statutory limits, make deductible contributions to an HSA. Employers as well as other persons (e.g., family members) also may contribute on behalf of an eligible individual. Employer contributions generally are treated as employer-provided coverage for medical expenses under an accident or health plan and are excludable from income. In general, a person is an "eligible individual" if he is covered under a high deductible health plan (HDHP) and is not covered under any other health plan that is not a high deductible plan, unless the other coverage is permitted insurance (e.g., for worker's compensation, a specified disease or illness, or providing a fixed payment for hospitalization). For calendar year 2015, the limitation on deductions is $3,350 (up from $3,300 for 2014) for an individual with self-only coverage. It's $6,650 (up from $6,550 for 2014) for an individual with family coverage under a HDHP. Each of these amounts is increased by $1,000 if the eligible individual is age 55 or older. For calendar year 2015, a "high deductible health plan" is a health plan with an annual deductible that is not less than $1,300 (up from $1,250 for 2014) for self-only coverage or $2,600 (up from $2,500 for 2014) for family coverage, and with respect to which the annual out-of-pocket expenses (deductibles, co-payments, and other amounts, but not premiums) do not exceed $6,450 (up from $6,350 for 2014) for self-only coverage or $12,900 for family coverage (up from $12,700 for 2014).

Taxpayer Bill of Rights

The IRS recently adopted a "Taxpayer Bill of Rights" to help taxpayers better understand their rights. While taxpayers already had these rights, they were scattered in various provisions of the Internal Revenue Code and were unknown to many taxpayers. They are now prominently displayed on the IRS's web site and fall into these 10 broad categories: (1) the right to be informed; (2) the right to quality service; (3) the right to pay no more than the correct amount of tax; (4) the right to challenge the IRS's position and be heard; (5) the right to appeal an IRS decision in an independent forum; (6) the right to finality; (7) the right to privacy; (8) the right to confidentiality; (9) the right to retain representation; and (10) the right to a fair and just tax system. ■

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