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- **Terms from the Glossary**

This month we will discuss some of the pitfalls in family and closely held business succession planning and ways to avoid or remedy them; and we provide more definitions of the “Terms of Art” that our clients have asked us about during the last month.

Cash Flow for the Surviving Spouse – If the deceased principal (we’ll call him “Owner” and presume that he is a him) has been taking out business cash flow as compensation and using it to support himself and his spouse and family, how will his spouse and family get that income after Owner dies?

Earnings are usually distributed from a company in the form of a declared or stated dividend or other declared income. If you assumed that a dividend will be miraculously declared for the first time on Owner’s death, think again. Who is going to declare it?

Let’s say Owner of an S Corp. has set up a trust for his surviving spouse and perhaps his children. (For the appropriate form of trust, see “Terms from the Glossary below.) If a son or daughter is the trustee of the trust, will that child declare a dividend to benefit his or her mother (or step-mother)? If the surviving spouse is the trustee and can unilaterally vote shares in favor or a dividend, what other intra family disputes might arise? Will one sibling act with equal loyalty to his or her full or step-siblings? How will your family act when the future of the company is at stake?

One rule that’s important to keep in mind is that when a person is acting as both a director of a company and as a trustee of a trust that owns shares in that company, the person’s fiduciary duties *as trustee* take precedence over his or her fiduciary duties to the company.

In the realm of a marital trust, however, this rule does not mean that if there is business income to be distributed or reinvested, the trustee-director must declare a dividend to provide income distribution to the trust and thereby to the surviving spouse.

If that is the result you desire, the terms of the marital trust should so direct the trustee.

A solution that is often overlooked in a family owned business setting is a written dividend policy that becomes effective at Owner's death. Such a policy would specify the amount, or how to determine the amount, of the dividend, its frequency and any specific events that would cause a dividend to be declared or not (earnings levels, for example). Such a dividend plan can be integrated into the shareholder's agreement for the company while Owner is alive and will result in a pre-determined income stream to the surviving spouse, other family members or trusts. Such a plan can go a long way to help avoid a family fight.

Another solution that may be appropriate is the purchase of life insurance on the life of Owner (the policy can be purchased and the premiums can be paid by a trust or by the company). Life insurance provides near immediate liquidity to address the cash needs of the Owner's surviving spouse and children. It can also leave a director-trustee free to reinvest the business earnings in the company.

Liquidity and Estate Taxes – This is perhaps the most common concern for family or closely held business owners and their families.

Estate taxes are due nine months after the date of death. If a family business was Owner's primary asset, and his estate does not have significant other liquid assets with which to pay any taxes due, the surviving family members may be forced to sell the business. Such a sale may not necessarily occur at market rates; fire sale pricing may apply.

As mentioned above, life insurance can provide liquidity to family members, a trustee or even the business itself, and can be used to pay estate taxes.

In addition, you can address liquidity concerns by planning while you are alive. A business succession plan can incorporate your preferences for whether illiquid assets should be sold and, if so, which ones. You can also provide for which assets should be used to address any taxes or estate administration costs.

And, there are two post-mortem tax planning techniques that may be available to help your family deal with illiquidity in your estate. Both depend on whether your closely held business assets represent at least thirty five percent of your adjusted gross estate (another Term of Art- see below). One rule allows the payment of estate taxes over fifteen years, at a nominal rate of interest. Another option permits the estate to redeem the shares of a closely held business up to the combined value of the taxes due and the funeral and administration expenses. The redemption is treated as a distribution in full payment in exchange for the stock so redeemed back to the company. The distribution, being the proceeds of a sale, is treated as capital gain and because the basis of the stock is stepped up to the date of death of the Owner, there is no capital gain. The rules governing installment payments of taxes and redemption of closely held company stock are highly complex, and professional tax and legal counsel is a wise choice.

Fiduciaries – Let's say that you have planned for a trust to own your closely held business assets and have named a family member as trustee. Unless the governing trust instrument provides otherwise, your trustee must act with equal loyalty to the lifetime (income) beneficiaries and the remainder beneficiaries (who may not yet have been born). This rule extends to the operation of a corporation whose entire stock is owned by the trustees in their individual and fiduciary capacities. This duty is in addition to the trustee's duty of undivided loyalty to the trust beneficiaries as

a whole. If a conflict develops between the personal interests of the trustee, and his fiduciary duties to the beneficiaries, the trustee must either subordinate his personal interests or resign.

Moreover, a fiduciary (trustee or executor) will be held liable for loss to an estate or trust that can be attributed to the fiduciary's failure to conduct a thoroughly documented review of the financial affairs of the business, to keep abreast of the company's operations, and to take such reasonable action as is appropriate to avoid unnecessary loss.

When planning for a fiduciary appointment to an estate or trust that has an interest in a closely held company, or when considering whether to accept such appointment and how to act, the responsibility for dealing with these potential conflicts of interest can be viewed in the context of four broad categories: *Due Diligence*; *Degree of the Fiduciary's Control*; *Fiduciary Powers in the Governing Instrument*; *Feasibility of the Plan*.

Coordination of Estate Planning Documents and Business Succession Planning Documents – Your professional advisors, including your business attorney, real estate attorney, and estate planning and tax attorney, whether at the same firm or at different firms, should consult regularly on what planning steps each has taken for your family. Here are some pitfalls to watch for:

Buy-Sell Agreements – Should provide that QTIP trusts for the surviving spouse are permitted owners or participants in the agreement. Otherwise, taxes that are deferrable until the death of the second spouse must be paid when the first spouse dies. Buy-Sell Agreements should also provide for lifetime transfers to descendants and trustees; any prohibition on such transfers can make it impossible to shift future appreciation to the next generation.

Wills – Should include gifting or other dispositive provisions that are consistent with any buy-sell agreements or other restrictions on ownership and disposition of assets.

Tax Apportionment or Charging Clauses – Such clauses, which are in wills and revocable living trusts, should be coordinated with the business succession plan. For example, any clause that requires that taxes be paid out of the residuary estate ignores that there may be little residuary estate left after transfer- on- death property, jointly owned assets, and assets governed by beneficiary designations, are all distributed. Moreover, if Owner leaves the business to his surviving spouse or only to some of his children as a specific gift, the children or heirs that take the residue will be expected to pay all the taxes. (And the same can happen with expenses of administration of the estate.) Tax clauses can be crafted to make all the assets responsible for their pro rata share of any estate or death taxes.

Thus, a properly structured and well thought out business succession plan is crucial to reducing estate taxes, avoiding the family fight, and ensuring that your “baby” continues through the next several generations.

Terms from the Glossary – Attorneys can toss around “terms of art” (not jargon) which puzzle clients. Clients asked us about the following such terms of art in the past month:

Qualified Subchapter S Trust – While a QSST can have only one income beneficiary, the beauty of a QSST is that the income beneficiary of such a trust is treated as the shareholder of the S Corp., and items of income are passed directly out to the income beneficiary and taxed in her income tax bracket, rather than in the trust's tax

bracket. The downside, however, is that the income beneficiary is responsible for any tax whether she actually receives a distribution from the S Corp. or not. Thus, it is the beneficiary who should elect QSST status, as she is electing to be taxed directly on the S Corp.'s income. QSSTs have other strict requirements.

Electing Small Business Trust – ESBT status is an election made by a trustee, not a beneficiary, and can be used for trusts with multiple “potential current beneficiaries,” each of whom is treated as a shareholder of the S Corp. A beneficiary is a person who has a present, remainder or reversionary interest in the trust. A “potential current beneficiary” is any person who at any time during a tax period is entitled to, or in the discretion of any other person may receive, a distribution from principal or income of the trust. Thus, a non-resident alien may be a remainder beneficiary of an ESBT, but if he becomes entitled to a distribution of any income or principal, he is then a “potential income beneficiary” treated as a shareholder of the S Corp. Because non-resident aliens are not permitted under the IRC to be shareholders of an S Corp., the trust would have to decide either to terminate the election or to divest itself of the S Corp. stock. Another downside is that the trust income attributable to the S Corp. is taxed at the trust's marginal rate, not the beneficiary's. Other complex rules apply.

Adjusted Gross Estate – AGE is a decedent's gross estate (everything the decedent owned at death), as determined for Federal estate tax purposes (think, e.g., of valuation discounts), minus the estate's total allowable debts, expenses and losses (including administration, funeral, and certain taxes).

Hot Off the Press – (Courtesy of Research Institute of America): The Senate has passed its resolution for the 2008 budget, including an amendment by Senator Max Baucus (D-Mont.) to preserve the estate tax for two extra years. The amendment freezes the 2009 status of the estate tax until 2012, creating a \$3.5 million exemption and a top estate tax rate of 45 percent. The Senate passed this amendment by a vote of 97 to 1, rejecting amendments that would have increased the exemption to \$5 million and reduced the rate to 35 percent, as well as an amendment that would have repealed the estate tax entirely. Those of you who remember your Civics classes will recall that the House writes the tax laws and the Senate has a vaguer role. So don't hold your breath; this bill must still be reconciled with whatever budget legislation the House passes.

For more information please contact us at 212-682-1555 or by email at info@maclean-law.com.

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