# Estate, Business and Succession Planning

New Strategies for Family Business Succession Planning

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**Jeffrey M. Fetter is admitted to practice law only in the State of New York, the State of Washington and the Commonwealth of Pennsylvania. The information contained in these materials is not intended to be legal advice, but is for discussion purposes only and is intended to merely convey general information related to legal issues commonly encountered in estate and business succession planning. Local legal counsel should be consulted with respect to any specific issues on which advice is desired.**

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Jeffrey M. Fetter is a shareholder and Chairman of the Business Practice Group of SCOLARO, FETTER, GRIZANTI, McGOUGH & KING, P.C. in Syracuse, New York. His practice focuses on business, estate, tax and succession planning for closely held and family owned enterprises. Services Jeff also offers his clients include: state, federal and international tax and business planning; estate and long term care planning; business and succession planning; e-commerce planning; employee and shareholder/principal relations and employee benefits; protection of intellectual property; transactional planning; acquisitions, dispositions, mergers, tax-free reorganization of business entities; entity structuring; contract negotiation, dispute resolution and the dissolutions of business entities.

He is a 1983 graduate of the Ohio Northern University College of Law. Clients Jeff represents are involved in agricultural businesses, professional service, manufacturing, communications and retail.

Jeff is a frequent lecturer for the New York State Bar Association and other professional and civic groups in the area of business and estate planning. He has authored several articles on business and estate planning for various periodicals.

## BUSINESS AND SUCCESSION PLANNING RELATED SERVICES

SCOLARO, FETTER, GRIZANTI, McGOUGH & KING, P.C. has established itself as a leading provider of legal and counseling services to the business community throughout New York and Pennsylvania. The firm represents Family Businesses, Family Business families and Family Business related businesses such as equipment dealers, equipment and product manufacturers, consultants and other service organizations in such diverse area as:

- Estate, Asset Protection and Trust Planning and Estate Administration
- Business Entity Selection, Organization and Representation
- Family Business Succession and Transition Planning
- Family Business Sales, Acquisitions, Mergers, Reorganizations and Development of Strategic Alliances and Partnerships Among Family Business Businesses
- Tax Planning for Family Businesses, Family Business Related Businesses and their Owners
- Contract Negotiation, Dispute Resolution and Litigation
- Real Property Purchases, Leases, Sales, Subdividing and Dispute Resolution between Adjoining Landowners
- Representation of Family Businesses in Stray Voltage Matters
- Personal Injury Matters for both Plaintiffs and Defendants
- Governmental Support Program Applications and Disputes
- Employment and Labor Matters
- Establishment of Retirement Plans for Owners and Employees
- Long Term Care Planning for Purposes of Protecting the Family Business

The firm has participated in thousands of successful Family Business transfers, each case presenting unique facts and circumstances that must be addressed. When representing Family Businesses and Family Business families, it is important to not only understand the general principles of business, estate and tax planning that are applicable to all businesses, but to also have a very clear understanding of the specific needs of the Family Business and its owners. Many Family Businesses and Family Business related businesses remain within the same family for many generations. As a result, it is necessary to understand and address the needs of multiple generations within and without the operation. Special emphasis is needed on ensuring that both the senior generation and the junior generations objectives are met when developing and implementing a Family Business succession plan. In many cases, there are both Family Business and non-Family Business heirs within the family and care must be taken to properly provide for everyone while protecting the primary asset of the family - the Family Business.

Although there are many similarities within various Family Businesses, each has unique and diverse needs. In most cases, this depends on the structure of the family, the structure of the Family Business and the present state of the business industry and the economy in general. Today's Family Business economy presents many challenges to the Family Business and to its advisors. Family Business income and expenses may vary greatly year to year and unlike many businesses, are influenced by factors outside the control of the Family Business's owners and management. It is important that the Family Business advisors work together as a team to address these challenges and to best serve the Family Business client. Over the past several years, the firm has established itself as an integral part of that team.

*Family Business Estate and Business Transfer Planning*

## PREAMBLE

*A few initial planning thoughts*

*Regardless of whether your plan is simple or complex, involves merely a will or sophisticated agreements among family and non-family members, the most important part of any plan is to* ***get it in writing!!!***

*Remember, the only time you need to use an agreement is if you cannot agree or if you're not there to speak for yourself. The parties to an agreement can always agree to something else but, . . . . if you cannot agree you need to go back to what you put down in writing.*

*Having your plan in writing helps to avoid disputes, confusion, tension, deterioration of the Family Business and the time and expense of having to end up in court.*

*Finally, the best time to implement a plan is yesterday!!*

## I. INTRODUCTION

A. Business Objective and Purposes. In any closely held corporation, limited liability company or partnership, the ongoing health of the business largely depends on keeping ownership of the business in the hands of those employees and/or family members who actually conduct the business. This is especially true in Family businesses where steps should be taken with respect to the business and estate plan to assure the owners' interest and investment in the business is protected and the interest is passed to the next generation or to the surviving owners with as little difficulty as possible. The objectives to be attained in a Family Business succession plan are:

1. Develop management and decision making structure for operation.

2. Minimize income taxes during operation and an estate tax as to both transferor and transferee upon transfer.

3. Establish terms under which plan will operate in the future to avoid need for future negotiations and to give all parties comfort that plan will be implemented.

4. Minimize personal liability and protect assets from third party claimants, including plaintiffs in legal actions, creditors and spousal claims in matrimonial actions in which Family Business members are parties.

## II. SUCCESSION PLANNING STRATEGIES

In implementing a Family Business succession plan it may be appropriate to utilize entity selection, estate planning documentation and agreements to establish the basis on which the succession plan will be structured, to provide retirement income to senior owners, to provide benefits, including incentive benefits to key employees and to establish a tax favorable means for passing the Family Business to the next generation whether family or non-family.

### A. Senior Generation's Objectives.

1. Retirement income and security.
2. Family Business continuation after retirement and death of parents.
3. Equitable or non-equitable treatment of Family Business and non-Family Business heirs.
4. Minimizing estate and income taxes for the parents and the next generation.

5. Reduction or elimination of management responsibilities for the parents (or the surviving spouse).
6. Protect assets for children and grandchildren with little if any exposure to creditors or spouses of children.

B. <u>Junior Generation's Objectives</u>.

1. Assumption of management responsibilities.
2. Attain or increase ownership.
3. Assure income needs of parents in retirement do not impair junior generation's earning capacity on Family Business.
4. Avoid involving non-Family Business heirs in management of operating entity.
5. Avoid unnecessary imposition of estate taxes/plan for payment of estate taxes through insurance policies on parents and/or partners.
6. Deductibility of retirement income payments to parents.
7. Establish credibility in community and with lenders/vendors/customers.
8. Establish operating agreements with partners setting forth terms under which operations will be managed and how an owner's interest will be transferred upon the occurrence of certain triggering events (e.g., death, disability, termination).

C. These documents and agreements may include the following:

1. **Buy Sell Agreements**. The buy sell agreement among the owners of the Family Business sets forth not only the terms under which owners will hold their interest while employed or associated with the Family Business, but also sets forth the terms and conditions under which an owner's interest will be transferred upon the occurrence of certain triggering events such as death, disability and termination of the owner's relationship with the Family Business.

2. **Management Agreements**. Setting forth how decisions will be made and the authority each of the managers and owners may have assures all principals that the decisions are being made by the appropriate individual or individuals.

3. **Prenuptial/Postnuptial Agreements**. Keeping the operation out of an owner's personal matrimonial proceeding not only reduces expenses to the Family Business operation, but can greatly reduce the emotional impact such an action may have on the entire enterprise.

4. **Estate Planning Documents**.

**The Absolutely, Positively Essential Estate and Health Care Planning Documentation (and then some).**

a. **The Will**. An owner's will sets forth the terms under which the owner's "estate" will be distributed upon death. Included within the "estate" is all assets owned by the owner at the time of death. Because the Family Business owner has both business and personal assets, it is important that a properly prepared will is in place to insure that the business assets pass in accordance with all the Family Business members' intentions.

Without a properly prepared will, assets will be transferred in accordance with the applicable statutes. For example, if a Family Business owner dies without a will and leaves a wife and three children, the applicable state law may provide that the wife will receive only a portion of the

assets. The remaining assets will be divided equally among the children (regardless of who is involved in the Family Business and who is not).

The estate plan should specifically address how Family Business assets as well as non-Family Business assets are to be handled at the time of death. In many Family Businesses, the active Family Business members do not want to have to involve their non-Family Business siblings in the day to day decisions that have to be made on the Family Business and what could be even worse is when the non-Family Business siblings have a financial stake in the operations. Properly prepared estate planning documents together with business planning agreements avoid these problems.

b. **Updated Health Care Power of Attorney.** Sometimes known as a health care proxy, this document ensures that people you have appointed are making health care decisions on your behalf in the event you are unable to do so on your own. An "updated" proxy is necessary that (1) specifically grants your agent authority to obtain records that are considered private under recently enacted "HIPAA" privacy regulations, and (2) appoints an alternate agent as well as a primary agent.

c. **Living Will.** The burden of having to make a decision as to whether life continuing measures should continue is a tremendous one. The living will sets forth your own wishes if such a situation arises and relieves your family and friends from having to be faced with such a decision. The living will sets forth your wishes and the conditions under which such a decision will be made.

d. **Updated Durable Power of Attorney**. A durable power of attorney appoints your agent or "attorney in fact" as the person who can take care of personal, business, financial and legal matters on your behalf. A power of attorney may be an "immediate power" or a "springing power". An immediate power of attorney grants this authority (which is great) in the hands of a person immediately. A "springing power" states the conditions under which such a power will come into place at some point in the future. E.g., in the event of your disability or illness which renders you unable to act on your own.

Because of the great power given under such documents, they should be carefully thought out before signing, but they are critically important to have in place to ensure that bills are paid, checks are cashed, assets are managed, children are provided for etc. in the event you are unable to act on your own.

Similar to the health care power of attorney, the durable power of attorney should also be updated if you already have one to include specific references to HIPAA and also to authorize your agent to make transfers of assets on your behalf in excess of $14,000.00 if those are your wishes. Under the form that is usually signed, there is a limitation on the amount of gifts that may be made. In some situations gifts in excess of that amount may be appropriate for medical, estate and financial planning. Again, care needs to be taken in designing the document that meets your wishes and expectations.

e. **The Sometimes Essential Trust Documents.** Trusts may also be used in connection with a Family Business Owner's estate plan. These trusts may be created during lifetime or at the time of the Family Business Owner's death. In both cases, the documents should be structured with the Family Business succession plan in mind.

(i) Revocable Trusts - purposes
  A. For avoidance or minimization of probate
  B. For asset management

(ii) Irrevocable Trusts
  A. For estate tax planning
  B. For asset protection planning
  C. For long term care planning
  D. For Special Needs planning

5. **Operating/Retirement Agreements**.

  a. **Deferred Compensation Wage Continuation Agreements**. It is not unusual to provide a reasonable amount of compensation to the withdrawing shareholder/employee or partner/employee in the form of a nonqualified deferred compensation agreement. Payments under a deferred compensation plan may avoid unnecessary FICA payments if properly structured.

  b. **Consulting Agreements**. Similar in tax substance to an employment agreement. However, consulting agreement payments will be subject to self-employment tax.

  c. **Employment Agreement**. In some cases, an employment agreement with the parent may be appropriate for security purposes; e.g., if the father wants to be assured he will receive guaranteed income, health insurance, etc., during his "active" and retirement years, an employment agreement would be a contractual obligation on the part of the Family Business to provide these benefits.

  d. **SIMPLE Plans, 401(k) Plans, IRA Options, etc.**

## III. ESTATE TAX PLANNING

A. **State and Federal Estate Tax Planning**. An estate plan primarily involves taking steps so that in the event of your death, your assets (whatever they may be) pass in the manner that you desire. However, estate planning also needs to take into consideration the possibility of estate taxes being due at the time of your death. These taxes are not paid by the decedent but by the estate of the decedent. If not planned properly, there may be the need to liquidate assets in order to pay estate taxes. In a typical Family Business entity this is not a desirable option because there is very little liquidity in the assets owned by the Family Business.

With properly structured estate planning documentation in place and the proper steps taken to reduce an estate during lifetime, estate taxes can be minimized or even avoided (legally). However, without the proper documentation and plan in place, it is possible that there will need to be a liquidation of assets in order to pay estate taxes. Although the IRS has payment plans, they are not always available and are not necessarily beneficial to the taxpayer.

### Federal Estate and Gift Tax Law Changes

There is continuous discussion about changes in the federal estate tax (or "death tax") but there can be no guarantee that this will ever take place. And, there is no certainty as to what will be the then current state of the law at the time of anyone's death. Presently, federal law provides that the exemption is $5,340,000 indexed for inflation. **But,** on January 1, 2013, the estate tax exemption was supposed to return to being

only $1,000,000. But, that didn't happen - remember the "Fiscal Cliff"? As discussed below, there is also the unexpected and unique opportunity to make gifts in amounts up to $5,340,000 without incurring a gift tax. This presents unique planning strategies that may only be with us for a short period time.

### New York Estate and Gift Tax Law Changes

New York recently enacted new estate and gift tax laws effective as of April 1, 2014. It was only a few years ago that New York's exemption was $115,000. As of April 1, 2014, the New York estate tax exemptions have been modified according to the following schedule:

These are known as the **"Basic Exclusion Amounts" or "BEAs":**

| | |
|---|---|
| 4/1/2014 – 3/31/2015 | $2,062,250 |
| 4/1/2015 – 3/31/2016 | $3,125,000 |
| 4/1/2016 – 3/31/2017 | $4,187,500 |
| 4/1/2017 – 12/31/2018 | $5,250,000 |

The basic exclusion amount is indexed after that point by a cost of living adjustment and is intended to match the federal exemption.

Because of the difference between the New York and the federal exemptions, any estate plans that were previously put in place should be reviewed to ensure that New York estate taxes are not unnecessarily due and payable upon the death of a person who leaves a surviving spouse.

**Although New York's recent legislation brought welcome relief in many respects, there are provisions in the new law which may in some cases create additional taxes for some estates over the next few years as the New York and federal exemptions come closer to joining together. In addition, New York's law contains certain provisions which essentially bring back a potential "gift tax" to New York for some estates - - which is payable at the time of death. It is possible that there could be additional changes made through corrective legislation to address these issues. Please see Appendix A - "Notes About the New York Estate and Gift Tax Law" for further information.**

Note also, that a "portability" feature was added to the federal estate and gift tax laws in 2010 that has continued to be in effect through the changes in the law. Portability essentially means that if one spouse passes away and does not utilize his or her full federal estate tax exemption, the surviving spouse is able to have that remaining exemption passed to him or to her. This is accomplished through filing a federal estate tax return and making the appropriate elections. There are very strict time limitations and very specific rules regarding how the exemption may be used and or retained by the surviving spouse which should be carefully reviewed in the event of the death of the first spouse to pass away. **Portability is for federal estate and gift tax purposes only, not state.**

### Pennsylvania Inheritance Tax Law Changes

Pennsylvania has enacted legislation that exempts "family farm businesses" from the Pennsylvania Inheritance Tax. Although this was welcome relief to family farm, it too has many limitations and definitions that must be met before it can be of any benefit to a family farming business, including when is a family farm not a family farm? I.e., is gas income greater than farm income? Is the land owned in an entity and/or used for purposes other than farming purposes? Etc. Etc.

Although estate taxes should not be the sole factor in structuring a Family Business succession plan, when structuring such a plan, it is important to at least know what the possible implications are and how they can be minimized. Advance planning is certainly necessary to avoid surprises.

A. **Long-Term Care Planning**. Family Businesses are for the most part more likely to pass from one generation to another than nonagricultural business operations. In addition, unlike many non-Family businesses there is significant value in the assets of the Family Business, but very little liquidity. These unique characteristics of a Family Business present very challenging obstacles if one or more family members require long-term care assistance, whether at home or in a long-term care facility. It is important to consider the disastrous impact these expenses can have on a Family Business and a Family Business succession plan. Early planning is needed. State law sets forth how the federal Medicaid program will be administered within the State. Under federal legislation implemented in 2006, the ability to transfer assets through gifting in order to qualify for Medicaid has become significantly limited. In most cases, transfers made within five (5) years of the date on which a Medicaid application is submitted will be disregarded.

   There are, however, planning opportunities that may be available depending on the facts and circumstances. In addition, consideration should be given to obtaining long-term care insurance while still healthy. The annual cost of such insurance is in most cases less expensive than the cost of one month's stay in a nursing home. In addition, the insurance expense may be partially or fully deductible at the federal level.

B. **Gifting**. As noted above, the estate tax exemptions have been increased to $5,340,000.00 for 2014. Historically, gift tax exemptions were not 'unified' with the estate taxes but now they are for federal purposes.

   The "lifetime" gifting exemption can be utilized at any time and the amounts in excess of any "annual exclusion" are then charged against the remaining estate tax exemption of the grantor. The "annual exclusion" gift is presently $14,000.00 per "grantee" and may be used for as many "grantees" as desired each year.

   Example: If a grantor gifts $114,000.00 to his son in either cash or other asset value, $14,000.00 is ignored for gift tax purposes and the remaining $100,000.00 would be credited against the $5,340,000.00 lifetime exemption thereby reducing the remaining exemption to $5,240,000.00.

   In cases where a gift is in excess of $14,000.00 a gift tax return must be filed with the Internal Revenue Service setting forth details of the gift, how its value was determined, etc. If the gift is made utilizing any "discounts" in valuation, a gift tax return must be filed regardless of the value. "Discounts" that may be utilized in valuing family or closely held businesses include "lack of marketability" (i.e. the asset is non-marketable because of its nature or because it is subject to a buy sell agreement among the owners of the business) or "minority interest" discounts which apply if the interest being conveyed does not carry with it control of the entity (e.g., nonvoting stock, minority ownership being transferred etc.).

   With increased gifting, opportunities exist for "freezing" the value of an asset in a person's estate. E.g., if $500,000.00 worth of land is transferred from parents to child, the future increase in the value of that land is outside the parents' estate. This then has been an effective "estate reduction" strategy because although a portion of the parents' lifetime exemption was utilized in making the gift, the increase in the value after the gift will no longer be charged against the parents' estate tax exemptions. Of course, asset selection is

important because if the value of the "gift" decreases, there is no future recovery of the exemption that was unnecessarily utilized.

As with any strategy there are advantages and disadvantages to making gifts during lifetime either to individuals or to trusts, **especially in light of the increased state and federal estate tax exemptions.** These include the following:

1. Once a gift has been made it may be outside the future control of the grantors (exceptions may exist if the gift does not consist of a controlling interest).

2. If a gift is made outright to an individual, that asset is now subject to the creditors of that individual, possibly spouses in matrimonial matters, plaintiffs, etc. If transferred to trust, there is much greater protection.

3. From a tax perspective a lifetime gift results in the forfeiture of a "step up" in basis upon death (which could have considerable tax savings in the future). This is discussed in the following section.

Any gifting plan should be carefully incorporated into the overall operations, management, estate and succession plan of the Family Business operations.

C. **Income Tax Planning in the Context of Estate and Business Succession Planning.**

Historically, planning has been based on avoiding the estate tax and in many cases, sacrificing the capital gains rate achieved through a step up in basis. The reason? State and federal estate taxes could reach 50% or more while the capital gains rate could possibly be as low as 15% - 20%. As a result, gifting was a desirable in order to remove the asset and its future appreciation from an estate.

With estate tax exemptions in excess of $5,340,000 and increasing over the several years, its important to carefully plan if, how and when gifts should take place. Today's estate tax exemption is approximately 8 times the exemption amount of the year 2001 - $675,000. In many cases, a family and the Family Business are much better off keeping the assets at the senior generation level and taking advantage of a step up in basis because there may not be an estate tax at all. However, other issues must be examined before such a decision is made such as:

1. How likely is it that assets will appreciate significantly?

2. Is "portability" available to shelter future estate taxes?

3. How important is it to transfer not only "control" of the Family Business, but the equity value of the Family Business to the next generation?

4. What is the likelihood that the "next generation" will sell the business (which is the point in time when the step-up benefit is realized)? Some Family Businesses will "never" be transferred - but is that a certainty?

5. Are there are other issues within the family and the Family Business which suggest that transferring the assets is beneficial? E.g., Long-Term Care Planning, Matrimonial Issues, Competency Issues, etc.

If there are reasons to make a transfer, but it is for reasons other than for estate tax planning purposes, other strategies may be considered such as utilization of an "incomplete gift" to a trust, voting agreements, etc.

An incomplete gift is beneficial because it can be in the context of an irrevocable trust such as an Income Only Trust so that the long term plan is relatively certain, but at the time of the Settlor's death, the value of the assets in the trust are still in the estate of the Settlor. However, careful planning must take place to ensure not only that the gift is truly "incomplete", but that the plan recognizes the need for family business succession.

D. **Key Man Protection/Profits Interest.** In many cases, "key employees" represent the next generation of the Family Business operation even if not related. There are many strategies that can be considered in ensuring that the key employees are properly compensated, incentivized for the future growth of the operations and in many cases are able to share in the ownership in the future. Some of these plans include the following:

1. Employee incentive plans based on profits, revenue, etc.
2. Deferred Compensation Plans that offer a retirement plan to key employees. These can be structured in a manner so that there are "vesting schedules" which provide that the longer an employee stays with the Family Business, the greater the benefit upon his or her retirement or departure.
3. Key man life insurance protection for the families of the key people.
4. "Profits Interests" in partnerships of LLC partnerships, pursuant to which the key employee can share in the growth of the value of the operations with very little if any up front tax consequences.
5. Restricted "stock" or "ownership" plans under which a key person is entitled to the issuance of ownership in the operations over a period of years.

These types of "key man" plans are not necessarily limited to non-related employees of the operation and can be utilized with family members as well. In such an event they are coordinated with the retirement plans of the "senior generation".

E. **Health Care Powers of Attorney, etc**. Although not technically "estate planning" documents, it is important to have up to date health care powers of attorney, living wills, and financial powers of attorney in place to ensure that in the event the "principal" is not able to make decisions involving personal or health matters that the agent appointed by the principal is making these decisions on their behalf instead of some other third party.

Also because of HIPAA regulations, it is important to have properly prepared and signed health care powers of attorney in effect for any individuals over the age of 18 to ensure that parents, family members, appointed agents, etc. are able to have access to medical information to provide assistance to the person. Otherwise, HIPAA does not allow the sharing of information vital to making decisions on behalf of an injured or incapacitated person.

## IV. CHOICE OF FAMILY BUSINESS ENTITY

A. **Objectives**.

1. Limited Liability and Protection of Assets.
2. Transferability of Interests.

3. Centralization of Management.
4. Minimizing Income Taxes.

B. **Tax and Non-Tax Considerations in the Selection of a Family Business Entity.**

| **Sole Proprietorships** | **Corporations** |
|---|---|
| **General Partnerships** | **Limited Liability Partnerships** |
| **Limited Liability Companies** | **Limited Partnerships** |

1. **Sole Proprietorship**. A sole proprietorship is a Family Business owned and operated by a single person. A business certificate may be filed in the county clerk's office if the business is operating under an assumed name. Income of the owner is reported on the taxpayer's 1040 through the various schedules (Schedule C for a business, Schedule E for real estate rentals, Schedule F for farming, etc.). E.g., eighty percent of family farming operations are operated as sole proprietorships.

   a. **Advantages:**

   (1) Very informal operation.
   (2) No formal requirements to organize.
   (3) Owner makes all decisions without having to be accountable to others.
   (4) No double taxation of an entity – all income reported on owner's returns.
   (5) Owner bound by acts of others in entity.
   (6) Ownership interest freely transferable.

   b. **Disadvantages:**

   (1) No limitation of liability for owner from contractual or tort liability.
   (2) Reporting of all income on Schedule F may be disadvantage – i.e., no opportunity to shelter income or to allocate between Self-Employment (SE) Tax Income and non-SE Income.
   (3) Limitation on ability to deduct certain benefits provided to owner and owner's family.
   (4) Tax liability is at owner's rate. If separate entity utilized could be opportunity to have lower tax rate or to share tax liability with others who have lower tax rate.
   (5) Unless preliminary steps are taken, entity disappears upon death of owner. Assets and real estate must be transferred individually.

2. **General Partnership**. A general partnership is an organization which is composed of two or more persons. A partnership can be created without a written agreement. However, it is advisable to have a partnership agreement. A certificate of doing business as partners must generally be filed in the county clerk's office. Partnerships are not taxed as a separate legal entity. They are "pass through" entities.

   a. **Advantages:**

   (1) Very easy to organize – few formalities, nominal operating costs.
   (2) Decision making process may be very informal if desired.
   (3) Detailed statute provides guidance on decisions making and on other matters concerning operation and dissolution if no agreement in place.
   (4) Pass through tax treatment for owners avoiding double taxation on operating income on the sale of assets.
   (5) Entity files Form 1065, not Schedule F.
   (6) Partnership interests are not freely transferable.

(7) May generally be liquidated tax-free/no double taxation.
(8) Flexibility in capitalization.
(9) May be easily converted to another entity (e.g., LLC or Corporation).
(10) Family Business partnerships can elect cash or accrual accounting.

b. **Disadvantages**:

(1) Unlimited personal liability for owners for acts of entity and acts of partners and employees acting in name of entity.
(2) Partnership interests are not freely transferable.
(3) Entity dissolves upon occurrence of certain triggering events (death, bankruptcy or withdrawal of a partner).
(4) Any partner may dissolve partnership by withdrawal.
(5) Each partner may obligate the partnership.
(6) Taxable year generally calendar year – partnership must conform taxable year to the taxable years of partners. I.R.C. §706(b)(1)(B)(i).
(7) Partners are not employees for purpose of deducting fringe benefits or for payroll tax requirements.
(8) Partnership return required even if no income. Exception for "small partnerships" under I.R.C. §6231(A)(1)(b) [ten or fewer partners, each of whom is natural person or an estate, and equal sharing of profits and losses].
(9) Partners taxable on income whether distributed to them or not. I.R.C. §701 (i.e., if a partnership has non-deductible expenses (e.g., mortgage principal or life insurance premiums), these may be taxable income although there is not necessarily cash to pay for those taxes to the partner.

3. **Corporation**. A corporation is a legal "person" that is created by filing of a certificate of incorporation generally in the Secretary of State's office. A corporation generally has perpetual existence. The owners or shareholders of a corporation have limited liability for the corporation's activities. A corporation is taxed as an entity separate and apart from its owners (unless S status is elected by the entity and its shareholders). S Corporation status is for income tax reporting only – no statutory differences between S Corporation and C Corporation under most states' laws.

a. **Advantages:**

(1) Limited liability of owners for tort and contractual liability of entity: liability limited to capital contribution that is utilized for purchase of shares. Exception: May also be state law exceptions for certain taxes (sales/payroll).
(2) Owners are not liable for acts of co-owners.
(3) Entity not terminated upon death, bankruptcy or withdrawal of owners (unless otherwise agreed in writing). Entity's existence may be perpetual.
(4) Interests (stock ownership) are freely and easily transferable (unless restricted by agreement).
(5) Ability to have centralized management (i.e., several owners but board of directors/officers selected to manage day to day operations.
(6) Ownership interests may be different among owners (i.e., voting/nonvoting interests, preferred/common interests) (there are limitations on S Corporations).
(7) If low profits, C corporation may allow use of lower tax bracket than pass through entity.

(8) C corporation offers the ability to deduct benefits payable to owners. S corporation's ability may be limited, similar to a sole proprietorship.
(9) Ability to retain profits and avoid taxation at personal level.
(10) Corporation laws throughout country are very similar and have long history of interpretation.
(11) Simple to create.
(12) Flexible capitalization requirements.
(13) Ability to select fiscal year.
(14) S corporation distributions not subject to self-employment tax. However, the IRS has announced it will begin review of wages and dividends paid through S corporations.

b. **Disadvantages:**

(1) Certain operating procedures must be followed to avoid piercing of corporate veil and resulting in personal liability for owners (i.e., annual meetings of shareholders, directors; maintenance of corporate minutes, etc.).
(2) Depending on tax structure (C vs. S) double taxation in operations and upon disposition of assets.
(3) S Corporation is restricted from having entities, certain trusts and nonresident aliens as shareholders. Maximum number of shareholders - 100.
(4) Upon incorporation, if liabilities assumed by the corporation exceed shareholders' basis in assets contributed, taxable gain results; I.R.C. §357(c). Otherwise, tax-free; I.R.C. §351. The basis of stock or securities received by the transferors is the basis of property transferred, less boot, plus gain recognized if any. I.R.C. §358(a)(1). If the corporation assumes a liability of the transferor or takes property of the transferor subject to any liabilities, the liability reduces the basis in the transferor's hands. I.R.C. §358(d). If there is debt in excess of basis, a taxable transaction results and gain is realized. I.R.C. §357(c).
(5) A corporate level tax is assessed against sales or exchanges of appreciated assets, that were acquired while the corporation was a C corporation, which are disposed of within 10 years after election of S corporation status. I.R.C. §1347(a). The rule does not apply to assets acquired after S election is made. This may reduce impact to agricultural operations if equipment, machinery are replaced. Except for land, most Family Business assets are replaced in three to six years (cattle, equipment, etc.). Therefore, built-in gains tax may not be a burden to a Family Business corporation.
(6) May be state-level assessments, minimum tax or filing fees applied each year.

4. **Limited Liability Company**. A limited liability company is a legal entity that offers its owners protection from personal liability but allows the entity's owners to be taxed as a partnership (unless the owners elect to be taxed otherwise). An LLC is created by filing "Articles of Organization" with the Secretary of State and entering into an operating agreement (LLCL §1203) or by converting a general partnership to an LLC on a tax-free basis. Some states allow for a statutory conversion. In other states, an LLC is created and general partnership interests are transferred to it.

a. **Advantages:**

(1) Owners enjoy limited liability for obligations and liabilities of entity and other owners.
(2) If Pass through entity – avoids double taxation.
(3) Flexibility in management and governance. Management may be by members or by managing members (similar to a board of directors).

(4) Ownership interests may be structured in a manner similar to corporation (i.e., voting/nonvoting interests, preferred/common interests).
(5) Common form of business operation internationally.
(6) Single Member LLC does not need to pay annual filing fee or to file separate tax return (report income on Schedule F).
(7) Simple to create. General partnership can convert to LLC tax-free. *PLR 9618021* (Feb. 2, 1996). Also, New York LLC Law allows for a conversion of a general partnership to a limited liability company.
(8) Multiple LLCs can provide allocation of income, protection of assets from liabilities of the other LLCs, etc.
(9) If taxed as a partnership, flexible allocation of income, distribution of assets, etc.
(10) LLC can elect whether to be taxed as a partnership, C Corporation or S Corporation.

b. **Disadvantages**:

(1) Similar to a corporation technical operating requirements must be followed in order to enjoy limited liability and to avoid piercing of the veil.
(2) Certain steps must be taken in operating agreement aid procedurally in order to avoid dissolution upon death, bankruptcy or withdrawal of an owner/member.
(3) May affect eligibility for certain farm benefit programs in the case of a family farm, but with the 2014 Farm Bill, this may not be of great significance.
(4) Must be careful to avoid unnecessary self-employment tax for those not active in Family Business. An LLC member is subject to self-employment tax or income of LLC if a member is a manager or if the LLC has no designated manager. Prop. Treas. Reg. §1.1402(a)-18.
(5) May be annual filing fees or minimum assessments imposed under state law.
(6) May not be easily converted to another entity (e.g., corporation).

5. **Limited Liability Partnership**. A limited liability partnership is a general partnership, the owners of which are protected against tort and contract liability for acts of the other partners or acts of the partnership itself. In some states (e.g., New York), LLPs may be composed only of certain professional firms (i.e., architects, accountants, physicians, lawyers, etc.).

6. **Limited Partnership**. A limited partnership is a partnership which has "general" and "limited" partners. General partners have unlimited liability for the acts of the partners and of the entity. Limited partners are not liable for the acts of the partners or of the entity itself and may not participate in management. LPs are taxed as a general partnership (i.e., a "pass through" entity). Limited Partnerships are created upon filing a certificate of limited partnership in the Secretary of State's office.

a. **Advantages**:

(1) Offers all advantages of partnership.
(2) Allows creation of interests that have limited liability (more attractive to investors).
(3) Having general and limited partners allows for centralization of management in the hands of the general partners.
(4) Flexibility as to allocation of losses and profits among general and limited partners.
(5) Limited partner interests are not subject to attachment by creditors – limited to charging order.

(6) Ability to transfer equity interests to others while retaining control by general partners. Note: IRS has recently been active in Tax Court challenging such arrangements.
(7) Form of entity may allow for greater valuation discounts to enhance ability to reduce estate values for owners' estate plans. Note: Entity must have a business purpose. It cannot be merely to discount value of interests.
(8) Only general partners may dissolve the partnership.
(9) A partner may be both a limited partner and a general partner at the same time.
(10) A limited partner's distributive share is not subject to self-employment income tax. 42 U.S.C. §411(a)(11), I.R.C. §77(c). Exception: If guaranteed payments are made as remuneration for services.

b. <u>Disadvantages:</u>

(1) General partners are personally jointly and severally liable for Family Business activities as in a general partnership.
(2) Limited partners may not participate in management or they risk loss of protection from liability for acts and obligations of entity and partners. A limited partner should have no participation in management. Personal guarantee of partnership's obligations could subject limited partner to liability for all partnership liabilities. Limited partner should not provide more than 500 hours of service per year. Prop. Treas. Reg. §1.1402(a)-2(h).
(3) Interests are not freely transferable.
(4) More costly and complex to organize than general partnership (filing requirements, publication requirements).
(5) May affect eligibility for FSA payments.
(6) General Partners subject to Self-Employment Taxes.

C. <u>Issues to Consider in the Selection of an Entity.</u>

1. Taxability of the entity and its owners.

2. Ability of owners to obligate the entity and other owners. Personal liability of the owners for actions and liability of themselves, each others and the entity.

3. Centralization of management within the entity.

4. Transferability of interests in the entity. Ability to restrict transferability by agreement.

5. Perpetual or limited existence of entity.

6. Expense of formation and technical requirements which must be followed in the operation of the entity.

7. Form of ownership interests; e.g., S corporations may not have entities and certain trusts as owners and number of owners is limited.

8. Flexibility with respect to allocations of profits and losses of entity.

9. Form of capital contributions being made, equity and non-equity, voting and nonvoting interests being created.

10. Does the entity fit within the owners' estate plans; e.g., only certain trusts may be shareholders of S corporations, may be desire to limit liability of estate for actions of entity etc.

11. What requirements are set forth in the statutes for resolution of shareholder, director disputes? (For example, the ability of a minority shareholder to petition a court for dissolution.) May a shareholders or partnership agreement govern instead of statute?

12. Events which may cause or result in dissolution and tax effects of dissolution.

13. Annual or other regular filing requirements are there for the entity? (For example, tax returns, filing requirements for state, confidentiality issues, etc.)

14. Need for keeping owners' participation on an anonymous basis.

15. Creation of multiple entities may meet family objectives (e.g., land held in one entity [e.g., LLC] with machinery, equipment, livestock in separate operating entity).

**New York State's Gross Receipt Base for the Calculation of the Fixed Dollar Minimum Tax**

| If the New York source gross income is: | S Corporation The fee is: | LLCs The fee is: | Partnerships The fee is: | C Corporation The fee is: |
|---|---|---|---|---|
| Not More than $100,000 | $ 25 | $ 25 | $ 0 | $ 25 |
| More than $100,000, but not over $250,000 | 50 | 50 | $ 0 | 75 |
| More than $250,000, but not over $500,000 | 175 | 175 | $0 | 175 |
| More than $500,000, but not over $1,000,000 | 300 | 500 | $500 if exactly $1 million | 500 |
| More than $1,000,000, but not over $5,000,000 | 1,000 | 1,500 | $1,500 | 1,500 |
| More than $5,000,000, but not over $25,000,000 | 3,000 | 3,000 | $3,000 | 3,500 |
| Over $25,000,000 | 4,500 | 4,500 | $4,500 | 5,000 |
| *Single Member Disregarded Entity: $25 fee regardless of income | | | | |

Although there was proposed legislation in the New York Assembly and Senate to reduce certain fees applicable to agriculture based entities, these have not been passed or enacted as of January 24, 2014

## V. SUMMARY

In a closely held business, generally the assets of the business make up most of the owners' estates. Although the objective of a family may be to perpetuate a family business operation for as long as family members wish to continue, outside pressures weigh heavily on the ability to do so. Estate and income taxes, dealing with Family Business and non-Family Business children, retirement issues, asset value issues, long term care issues, etc. all add to the complexity of putting together a plan that can withstand these outside pressures and result in a successful multi-generational plan.

It is important to plan early in order to develop a comprehensive plan that can address all the "what ifs" that come along in the life of a family business. Once implemented, the plan needs to be monitored and maintained in order to ensure that it continues to be up to date and reflect the intentions of the family. Laws continually change as do the facts and circumstances surrounding a family and a family owned business. To ignore these changes can be as devastating as not having any plan in place at all.

Regardless of how large or small an operation is, it is imperative to have an advisory team working with the family and the Family Business owners. These advisors can provide valuable insight not only to family members but to other members of the advisory team to ensure that the plan is properly structured and works well into the future.

1. Family Business succession planning must take into consideration the likelihood that an owner and a spouse may be divorced at some point in the future. In order to protect "Family Business assets", appropriate agreements should be entered into prior to the marriage.

2. The Family Business must be protected from disruption whether it is a two-person husband and wife operation or a multiple owner entity with related and unrelated individuals as owners.

3. Agreements should be carefully designed, depending on the facts and circumstances surrounding the marriage and the Family Business operations.

4. Review agreement periodically to determine if the agreement is consistent with the structure of the Family Business and the estate plans of the owners of the Family Business. A review may be appropriate at the same time that a client would review his or her estate planning. That is, if there have been changes in Family Business ownership, financial situations, family situations, or in the tax and other laws that affect a Family Business' operations, the agreement should be reviewed.

5. In a multiple generation Family Business, remember to express to parents that, in the past, one of them was the "in-law". Therefore, it may be appropriate to terminate or modify agreements at some point in the future.

6. Keep tax considerations in mind when discussing and entering into a prenuptial or postnuptial agreement. It is difficult to determine the most tax advantageous provisions to include in a prenuptial agreement when the effective date of a split up is (1) not contemplated and (2) many years in the future. Therefore, the need to periodically review the agreement remains necessary (keeping in mind that at least one of the parties probably would prefer not to have an agreement at all, and this can be re-raising a very sensitive issue within the family (and within the Family Business).

7. Be consistent with all the Family Business owners. If a prenuptial agreement is necessary for one owner, it should be necessary for all owners. The buy-sell agreement must be kept up-to-date to reflect the then current intentions of the parties.

Unless expressly stated otherwise above, (1) nothing contained in these materials was intended or written to be used, can be used by any taxpayer, or may be relied upon or used by any taxpayer for the purposes of avoiding penalties that may be imposed on the taxpayer under the Internal Revenue Code of 1986, as amended; (2) any written statement contained in these materials relating to any federal tax transaction or matter may not be used by any person to support the promotion or marketing or to recommend any federal tax transaction or matter addressed in this message; and (3) any taxpayer should seek advice based on the taxpayer's particular circumstances from an independent tax advisor with respect to any federal tax transaction or matter contained in this message. No one, without our express written permission, may use any part of these materials in promoting, marketing or recommending an arrangement relating to any federal tax matter to one or more taxpayers.

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# APPENDIX A

## Notes about the New York Estate and Gift Tax
## Courtesy
## of
## John S. King

## SCOLARO, FETTER, GRIZANTI, McGOUGH & KING, P.C.

1. **Phase-Out of the Basic Exclusion Amount ("BEA")**. The BEA is *fully phased-out* by the time the taxable estate equals 105% of the BEA. As a result, for taxable estates between 100% of the BEA and 105% of the BEA the effective tax rate exceeds 100%. The New York estate tax on a taxable estate of $2,114,063 (102.5% of the BEA) is $66,568. The New York estate tax on a taxable estate of $2,165,625 (105% of the BEA) is $112,050.

| DOD Between: | 105% of Basic Exclusion Amount | $ Excess over BEA | NY Estate Tax on Excess |
|---|---|---|---|
| 04/01/2014 – 03/31/2015 | $2,165,625 | $103,125 | $112,050 |
| 04/01/2015 – 03/31/2016 | $3,281,250 | $156,250 | $208,200 |
| 04/01/2016 – 03/31/2017 | $4,396,875 | $209,375 | $324,050 |
| 04/01/2017 – 12/31/2018 | $5,512,500 | $262,500 | $452,300 |

The effect of the phase-out of the BEA, however, is to put taxable estates of the same size (once in excess of 105% of the BEA) in the same tax position as before the change in the law.

| Taxable Estate | DOD pre 04/01/2014 | DOD post 03/31/2014 |
|---|---|---|
| $1,000,000 | $ -0- | $ -0- |
| $1,500,000 | $ 64,400 | $ -0- |
| $2,000,000 | $ 99,600 | $ -0- |
| $2,062,500 | $104,100 | $ -0- |
| $2,250,000 | $118,800 | $118,800 |
| $2,500,000 | $138,800 | $138,800 |

2. **Planning for the New York Estate Tax Rate in Excess of 100%**. Consideration should be given to special planning for estates that exceed 100% of the BEA but not 105% of the BEA. In cases such as this, in effect, New York State is giving estates money if the decedent sets up his or her plan so that a deduction (probably charitable) is implemented to reduce the taxable estate to the BEA. Consider this example:

> Decedent dies in 2014 with a taxable estate (before any charitable deduction) of $2,165,625. The New York estate tax is $112,050 and the heirs will receive $2,053,575. If the decedent's Will includes a charitable deduction designed to reduce the estate to 100% of the BEA

of $2,062,500, the New York estate tax is $-0- and the heirs receive the full BEA amount of $2,062,500 – an increase of $8,925 representing "free money" to the heirs.

A Decedent dying in 2017 with a taxable estate (before charitable deduction) of $5,512,500 who implements a similar charitable plan generates for the heirs "free money" amounting to nearly $190,000.

Another method of keeping the taxable estate at or below the BEA is the use of regular Annual Exclusion gifts or "death bed" Annual Exclusion gifts. Gifts of this type, however, require constant oversight of the size of the client's estate and the ability to move quickly – perhaps via a Durable Power of Attorney – in order to make the necessary gifts.

3. **Portability**. New York does not recognize portability of the BEA from one spouse to the other.

4. **Gifts Made Within Three (3) Years of Death**. Certain gifts made after April 1, 2014 and within three years of the decedent's death are included in the New York taxable estate. The three year rule does not include:

a. Annual Exclusion Gifts
b. Gifts Excluded under IRC section 2503(e) (tuition/medical)
c. Gifts otherwise included in the decedent's federal taxable estate
d. Gifts made before April 1, 2014
e. Gifts made after December 31, 2018
f. Gifts made when the decedent was not a resident of New York

## Interaction of Important Planning Factors

For decades, the potential for the imposition of significant federal and state estate taxes drove much of the decision making in estate planning. As recently as 2001, when the federal estate tax exemption was $675,000, the maximum federal estate tax rate was 55% and the credit for state death taxes generated a (mostly) uniform state estate tax, most clients of even modest wealth focused their estate plans on the minimization and deferral of estate taxes. The use of an "optimal marital formula" plan accomplished this for many clients and often was the starting point for most advisors.

Today, with (i) a federal estate tax exemption of $5,340,000 (*nearly 8 times that of 2001*), (ii) a maximum federal estate tax rate of 40%, (iii) portability available for couples and (iv) a New York estate tax exemption on its way to equaling the federal exemption, the traditional Optimal marital formula may not be the best default estate plan. This is especially true when combined federal and New York income tax rates can potentially exceed 40%.

Couple these transfer tax and income tax changes with the increasing cost of long-term care and changing family dynamics and it becomes clear that a "one size fits all" plan for clients of modest wealth

may no longer be appropriate. Factors that had been somewhat secondary in the planning process may now be of primary importance – and those factors are likely to differ from client to client and family to family.

1. **Transfer Taxes (Federal and New York State).**

For combined estates that are not likely to exceed one (1) federal estate tax exemption, planning for transfer taxes is likely of little concern to most clients. However, because New York does not allow portability of the basic exemption amount there will continue to be planning complications at least until the federal and New York estate tax exemptions are the same.

If the combined estates will likely exceed one (1) federal exemption but not two (2), portability will likely handle the federal tax concerns but transfer tax planning for the New York estate tax remains an important aspect of estate planning. The use of a trust in the first estate will be necessary in order to minimize New York tax

2. **Asset Protection Through Estate Planning.**

One of the risks of transfer taxes no longer being the driving force behind many estate plans is the belief that an outright bequest to a surviving spouse or children (a basic "I Love You" will) is the appropriate default plan. One of the key benefits of using testamentary trusts in an estate plan is that trusts provide asset protection for the trust beneficiaries – whether a surviving spouse or others. In this context, the term "asset protection" means the protection of inherited assets from many of the pitfalls of family life such as: (i) the potential of a beneficiary's divorce or second marriage, (ii) potential claims of a beneficiary's "traditional" creditors, (iii) the potential for a spendthrift beneficiary to waste his or her inheritance and (iv) the protection of inherited assets from being expended for a beneficiary's long term care expenses. As the use of trusts becomes less prevalent for tax planning purposes, the importance of considering trusts for their asset protection benefits becomes much more important.

In an estate plan where transfer taxes may be of secondary concern, testamentary trusts can be implemented in several different ways.

a. Traditional Disclaimer Plan. Under a traditional disclaimer plan all or a portion of the estate is left outright to the surviving spouse. If the spouse chooses to disclaim (or renounce) all or a portion of the inheritance then the disclaimed portion drops into a trust for the benefit of the spouse (and if so designed, other family members as well). The transfer tax effect of such a disclaimer is that the disclaimed assets pass to the "Disclaimer Trust" as if the spouse had predeceased the testator and thus are not considered a gift by the disclaiming spouse. Furthermore, the Disclaimer Trust is not a part of the disclaiming spouse's estate for estate tax purposes. With one important exception, the Disclaimer Trust provides the asset protections mentioned in the preceding paragraph.

For Medicaid planning purposes, however, a disclaimer is treated as being a transfer by the disclaiming spouse and thus is subject to the 5 year look-back provisions. Moreover, a disclaiming spouse cannot be granted a power of appointment over the Disclaimer Trust which drastically limits future estate planning flexibility.

b. Clayton QTIP Trust. A corollary to the Disclaimer Trust is the "Clayton QTIP Trust". With a Clayton QTIP the portion of the estate left to the surviving spouse is left to a QTIP Trust for the sole benefit of the survivor. If the Executor of the estate chooses not to elect QTIP treatment for all or a portion of the trust then the non-QTIP-ed portion drops into a trust for the benefit of the spouse (and if so designed, other family members as well). While this plan looks like a traditional disclaimer plan, the choice of funding the non-QTIP trust belongs to the Executor – not the surviving spouse. The transfer tax consequences are the same as with the traditional disclaimer plan.

The asset protections mentioned above are available with a Clayton QTIP plan and the surviving spouse can hold a power of appointment over the non-QTIP trust. Finally, because the Executor is making the decision to fund the non-QTIP trust its funding should not be considered a "transfer" for Medicaid planning purposes. Out of an abundance of caution, however, it is recommended that an Executor other than the surviving spouse be given the authority to make the QTIP election decision.

c. Traditional Trust Planning. Under many circumstances it may be appropriate for an estate plan to mandate the creation of a trust for the surviving spouse (and others, if desired) without any need for a disclaimer or Clayton QTIP election. Such a plan is most appropriate where there are clear reasons for such a trust – for example, where the surviving spouse is expected to require long-term care, where the testator has other asset protection concerns or where transfer tax concerns warrant trusts.

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