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Volume 4
**Preserving personal
and family wealth**



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How to hang on long after you've let go

Business succession is a long-term process of planning and preparation, but there comes a moment when the leader and the led part ways — when one story becomes two. In this series much of the focus is on the business, how to prepare it for new leadership, and how it should go forward. But the retiring leader's story is just as important.

Like other elements of succession planning, a broad-based approach to lasting personal wealth should begin years before the separation. What many people fail to appreciate is that personal wealth management in a post-succession life stage is not always about complete independence from the business. Some financial ties may endure long after you sever the management ones.

This volume explores the particulars and strategies that contribute to the preservation of the individual welfare and personal financial security of company owners and their families. The plan you make for your business can have significant and often surprising effects on the plans you make for yourself in retirement. The financial futures of other key stakeholders are in play as well. In the following pages, we'll examine critical topics like individual retirement goal setting, estate and gift tax strategies, life insurance planning, and investment portfolio strategy.

Retirement planning

Retirement planning is a challenge for any professional who contemplates the end of a working career. For many people, the term evokes a pool of saved or invested wealth. For business owners, however, the outlook is different. In addition to savings, retiring owners may work to create sustainable cash flows that continue to flow from the businesses they've left. In some cases, they may also rely on installment proceeds from the sale that ended their tenures.

Retiring owners who set up these income streams and plan to depend on them need to confirm that the source of cash flow is adequate and protected. Retirement planning for closely held business owners can be especially challenging in the frequent cases when a closely held business owner's retirement plan is linked to other critical issues like developing the next generation of leaders, estate and gift tax planning, stock transfer techniques, valuation, and corporate finance.

A retirement strategy starts with goal setting. What is your vision of retirement? Do you envision spending any time at work, or will you withdraw completely from managing the business? What sort of lifestyle does "retirement" mean in your view—and how much money will it take to make that vision come true?

Be realistic in your goal setting. A future retiree without a clear picture of potential requirements is more likely to fall short of what he or she needs. Some people will map out retirement cash flow levels that are far less than their pre-retirement expenses, while others may actually plan to increase their spending after retirement. The important thing is to understand those desires — and to quantify them in as much detail as you can.

With a goal in mind, consider what may affect your path to realizing it. Does your plan expose you to the ups and downs of the stock market? Will health needs, family obligations, or taxes make the cash flow you've arranged for feel less adequate a few years from now?

You wouldn't have this wealth to plan for if you weren't skilled at managing variables. Apply that same acumen to your retirement. Use hard data and analyze it to determine what's realistic. Instead of a single-track plan, identify contingencies and alternatives. Turn every wish-list item into a concrete action plan, then confirm those plans for your future are compatible with the plans you're setting in motion for your business.

Once you've established a retirement plan, don't set it in stone. Review it periodically to make sure it's tracking with reality. Don't think of retirement as the absence of a job; think of it as a new job — safeguarding and enjoying the rewards you've worked hard to accumulate.

Turn every wish-list item into a concrete action plan, then make sure all those plans for your future are compatible with the plans you're setting in motion for your business.

Estate and gift taxes

Closely held business owners accumulate net worth in their business holdings that subject them to federal and state estate taxes. As one of these owners, you might not have a clear sense of the value of your company, but the tax rules are definitive. There is a value, and it will affect your liabilities as you move into retirement. It will also influence the way you and your family members can inherit wealth when one of you dies.

The federal transfer tax system consists of three separate and distinct taxes — the estate tax, the gift tax, and the generation-skipping transfer (GST) tax.

Legislative history and your future

Step back more than a decade. The Economic Growth and Tax Relief Act of 2001 (“EGTRRA”) was part of the package known commonly as the “Bush tax cuts,” whose programmed sunset and partial extension remained a focus of policy debate well into the Obama Administration.

EGTRRA included significant changes to the estate, gift and GST tax rules, ultimately providing for “repeal” of the estate tax and no generation-skipping transfer taxes in 2010. EGTRRA gradually reduced the top effective estate, gift and GST tax rate from 55 percent in 2001 to 45 percent in 2009 and increased the estate tax and GST tax exemption amount through 2009 (with an unchanged gift tax exemption of \$1 million). In 2010, EGTRRA repealed the estate tax and further reduced the gift tax rate to 35 percent, leaving the gift tax exemption at \$1 million. EGTRAA also specified that no GST taxable event could occur in 2010.

Importantly, EGTRRA contained a “sunset provision” that would have reinstated the estate, gift and GST taxes to pre-2001 rules starting in 2011 if no congressional action were taken.

As EGTRAA provisions were set to expire, The Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010 (the “2010 Act”) became law. This included temporary estate and gift tax benefits for 2011 and 2012. Under the 2010 Act, the estate taxes were reinstated to the beginning of 2010 with an exemption amount of \$5 million per decedent and a top rate of 35 percent. The estate and gift tax regimes were reunited in 2011, with an exemption amount of \$5 million and a top rate of 35 percent. Similarly, the GST tax exemption amount was also increased to \$5 million and a rate of 35 percent. The gift, estate and GST tax exemption amounts were then indexed for inflation in 2012 at an amount of \$5.12 million.

The 2010 Act also allowed the estates of decedents dying on or after January 1, 2010 and before January 1, 2011, to opt out of the 2010 Act’s estate tax regime and apply 2010 law, which substituted modified carryover basis rules for the repealed estate tax. The election out of estate tax and into modified carryover was complex—and, once made, was irrevocable. For beneficiaries of estates that made this election, assets were generally inherited with the same basis as the decedent had prior to death, with certain modifications.

The 2010 Act also allowed for portability of the unused exemption amount for decedents who died in 2011 and 2012 to the surviving spouse, allowing the surviving spouse to use his or her own exemption plus the unused exemption amount from his or her most recent deceased spouse to offset the tax on subsequent gifts or to offset his or her estate tax. In order for the decedent’s unused exemption amount to be available to the surviving spouse, the executor of the deceased spouse’s estate had to make an election to convey it and compute the amount to which the surviving spouse was entitled. The GST tax exemption, however, was not portable.

If Congress had not acted, the sunset of the 2010 Act would have taken place. The estate and gift taxes in 2013 were set to be calculated using an exemption amount of \$1 million, a top rate of 55 percent and a 5 percent surtax on transfers in excess of \$10 million until the lower tax brackets and applicable credit amount were recaptured. The GST exemption was set to be \$1 million at a rate of 55 percent.

But the American Taxpayer Relief Act of 2012 permanently extended the estate and gift tax regime, with the exception of the tax rate. The estate and gift tax exemption amount remained at \$5 million, adjusted for inflation each year thereafter. The top rate is set at 40 percent. The inflation-adjusted exemption amounts for 2012 and 2013 were \$5.12 million and \$5.25 million respectively; the 2014 inflated-adjusted exemption amount is \$5.34 million. Similarly, the GST exemption amount was also permanently extended and will remain at \$5 million indexed for inflation from 2012 with a tax rate equal to the highest gift tax rate in effect at 40 percent. The inflation-adjusted GST exemption amount for 2014 is therefore \$5.34 million. Another significant extension with the 2012 Act includes portability of a deceased spouse’s unused estate and gift tax exemption.

What this means for you

The 2012 Act results in significant changes for individuals who attempt to plan their estates in the foreseeable future. Because the 2012 Act provides for a significant increase in exemption, which will be adjusted for inflation, individuals will need to revisit their estate plans going forward.

The wealth of closely held business owners is typically tied up in illiquid assets. So without proper estate planning the estate tax may force heirs to sell the business in order to pay the tax.

The table below shows how the applicable rates and exemption amounts have changed through 2014. It is vital for closely held business owners to understand this as a dynamic environment — governed not only by complex rules, but by rules that have not remained constant. There are elements of a post-retirement plan for which it's difficult to plan, and estate taxation triggered by a death in the family is certainly one of those. But you and your family will still be better off knowing the legal context than if you don't.

Estate gift, and generation-skipping transfer (GST) tax: maximum rates and exemption amounts

Year	Rate	Estate and GST exemption	Exemption
2010	35%	\$ 5,000,000*	\$ 1,000,000
2011	35%	\$ 5,000,000**	\$ 5,000,000
2012	35%	\$ 5,120,000**	\$ 5,120,000
2013	40%	\$ 5,250,000**	\$ 5,250,000
2014	40%	\$ 5,340,000**	\$ 5,340,000

* Unless executor elected modified carryover basis rules.

**Increased by amount unused by first spouse that carries over to a surviving spouse, if elected



Building an estate plan entails more than setting up wills, trusts, and health-care directives. The first step is to determine the extent of estate tax exposure in order to prepare the way for further succession planning. To determine the value of your current estate and for assistance in projecting its future value, it's a good idea to talk to a professional financial advisor. Reviewing the situations and strategies that follow is a valuable way to prepare for that conversation.

When developing an effective estate and gift tax plan, you should also consider other elements of succession planning, such as developing and motivating management talent, transferring ownership, retaining key employees, dealing fairly with family members who may or may not be actively employed in the business, disability planning, retirement planning, and investment portfolio strategies. Other volumes in this series treat many of these issues in detail.

Lifetime gifting

Gifting can be a very simple and powerful way to transfer wealth from one individual to another without incurring a transfer tax — especially when the gifting program unfolds over a period of years. After a gift is made, the asset is removed from the donor's taxable estate, so any future appreciation on the gift is removed from the donor's taxable estate as well. The trade-off in making a gift is that the recipient of the gift gets the same tax "basis" in the property received that the donor had prior to the gift. If the same property were bequeathed at death instead, the recipient would receive a free "step-up" in basis in the property.

Any individual may give up to \$14,000 of value to another individual each year without paying any transfer tax — and without eating into the lifetime credit against estate and gift taxes that everyone is allowed under the law. Married couples can give \$28,000 per year per recipient. And the \$14,000 and \$28,000 amounts will be adjusted for inflation.

In order to qualify as a bona fide gift, the donor must give up all rights of ownership and control. Attach any strings, and the gift and its tax benefits will be nullified. There are a few special cases — for example, gifts for tuition and medical expenses can be made free of gift tax consequences, as long as the checks are made payable directly to the school or medical service provider.

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Using trusts in estate planning

Trusts are widely used in estate planning, largely because they're very flexible. You can create and fund a trust during a lifetime (inter vivos trusts) or create one by the terms of a will or trust at death (testamentary trusts). The terms of some trusts may allow it to be changed or even revoked by the grantor. Other trusts may be fixed or irrevocable at the date of creation.

In estate and financial planning, there are several common purposes for using trusts.

- **Managing assets.** The responsibility for making investment decisions and maintaining adequate records can be transferred to either a corporate or an individual trustee.
- **Protecting assets.** In certain situations, a properly drafted trust can protect the assets in a trust from creditors of a beneficiary. In addition, the assets may be protected from a spouse in the event of the divorce of the beneficiary.
- **Providing privacy.** The assets, terms, and conditions of a trust are generally not subject to public inspection.
- **Avoiding probate.** The assets that are held in a trust created and funded during the grantor's lifetime are controlled by the terms of the trust, not by the terms of probate. In some states, avoiding probate can save time and reduce administrative expenses.
- **Providing for multiple beneficiaries.** A trust can be created for the benefit of multiple beneficiaries and can allow the trustee to use discretion in making distributions.
- **Providing for special needs.** A beneficiary may have a special need relating to education, health, and so on. A trust can be used to address those special needs.
- **Tax planning.** A trust can be used to help take full advantage of the combined marital deduction and the estate tax credit while assuring that assets can be available to meet the needs of the surviving spouse. For example, your will could leave all your assets to your spouse except the amount equivalent to the estate tax exemption amount. This amount would go into a "by-pass" or "family" trust for the benefit of your spouse and family. Although your spouse would be able to benefit from the entire estate, the trust assets would not be included in the estate of the surviving spouse on his/her subsequent death.



You can implement a trust during your lifetime or under the terms of your will. Or you can establish a trust during your life to begin operation upon your death. In that case, property that passes under the terms of your will could be directed to “pour over” into an existing trust.

You can use a trust established during your lifetime (“inter vivos”) to plan for certain types of assets, like insurance proceeds and employee benefit plans. If these are made payable to the trust, the trustee could collect them immediately following your death without the potential delay and administrative difficulty that may be associated with a “testamentary” trust established under your will. In some states, this approach has the added benefit of avoiding the continuing probate court jurisdiction sometimes imposed on trusts established under wills.

In fact, it may be beneficial to place title to certain assets in an inter vivos trust, and to designate yourself as trustee during your lifetime, to avoid the probate process. Such arrangements are often referred to as a self-declaration trust or living trust. They can be effective in reducing probate time and expenses and avoiding publicity and unnecessary trustee fees during your life.

In creating a trust, be careful in your choice of a trustee — the individual or institution that will be responsible for the management, investment, and distribution of funds. As with any person in any role, the competence of the person you select will vary. Not everyone has the same business judgment or experience.

If you choose an institution instead of a person, remember that an institutional trustee’s existence is “perpetual.” An appointed individual may die or become incapacitated, which negates the continuity of trust administration. If you want to name an individual as trustee, you should consider naming a corporate trustee as a backup if the individual is later unable or unwilling to serve. This highlights one of the advantages of a trust: its flexibility to adapt to changing circumstances. While a trust is generally irrevocable following the death of the individual who created it, you can include a provision that gives the beneficiary the ability to replace the trustee. This authority can be granted to any individual, but typically it’s reserved for an adult beneficiary, such as the surviving spouse.

A corporate trustee can provide management and record-keeping expertise for almost any type of asset and is typically trained in the responsibilities of serving as a fiduciary. In addition, the corporate trustee’s existence is generally enduring. You can count on it to be there long into the future to respond to the needs of your beneficiaries. But there are fees associated with the selection and use of a corporate trustee. It is important to weigh the costs and benefits of engaging such professional expertise according to the situation. You may want to consider naming both a professional and another relevant individual as co-trustees. That way, you can combine professional management expertise with the individual’s knowledge of the family and the needs and circumstances of the individual beneficiaries.

In creating a trust, be careful in your choice of a trustee... As with any person in any role, the competence of the person you select will vary.

Life insurance

Life insurance is a common approach taken to limit estate tax exposure. That's because it can provide instant liquidity on a tax-free basis at the precise point when the cash is needed: upon the death of the insured. Married couples often buy "second-to-die" policies (where the death benefit is not paid until the second member of the couple dies) because the premiums are lower. Often, depending on the will, the bulk of the estate tax isn't due until the second spouse dies, because of the marital deduction afforded transfers between husbands and wives.

But it's not all good news. If the policy is owned by the decedent, the death benefit from the life insurance policy is included in the decedent's taxable estate. If this is the case, the current tax rates may tax up to 45 cents per dollar of insurance death benefit. One solution is to place the insurance in, or to purchase the policy through, an irrevocable trust. The trust must be properly structured and funded so there are no "incidents of ownership" that would cause the death benefit to be drawn back into the decedent's estate.

Often an individual will own permanent life insurance policies and will want to transfer the existing policies to a life insurance trust in order to remove the death benefit from the taxable estate. Take care when implementing such a strategy. The first potential trouble spot is called the "three-year rule" — if a taxpayer transfers an existing policy to a trust, and the taxpayer dies within three years of the transfer date, the face value of the policy will be brought back into the taxpayer's estate. Another complication in the life insurance area is the "transfer for value" rule. If a taxpayer transfers a life insurance policy for value (in a non-gift transaction), the death benefits may be re-characterized as taxable income when they're received. There are exceptions and tactics you can employ to account for the "three-year rule" and the "transfer for value rule." The key to navigating around potential pitfalls is to seek the advice of an estate tax specialist before taking action.

Generation-skipping tax

The estate tax is imposed upon each generation at death. Going one generation at a time, your bequest would go through taxation twice before it gets to your grandchildren. So many individuals seek to "skip" a level of transfer tax by transferring wealth directly to their grandchildren. This was possible before 1986.

In that year, Congress enacted the generation-skipping transfer tax that taxes direct generational "skips" at the highest marginal estate tax rate. During the course of a lifetime, each individual is allowed to transfer an amount up to the generation-skipping exemption amount seen in the table on page 7 to individuals of two or more generations removed without incurring the generation-skipping tax.

If you want to use a generation-skipping tax strategy, you have to account for potential challenges. Some common trouble spots include:

- Leaving property outright to a grandchild or great grandchild while the "lineal ancestor" (his or her parent) is still living
- Leaving property in trust to a child, with the remainder to a grandchild, where the property is not included in the child's estate
- Leaving property in trust from which the trustee pays out amounts to a grandchild while the child is still living

Taken to its deepest level of detail, the generation-skipping tax could be the subject of its own book. But know there are approaches that can address these complications. There are also planning structures you can employ to help preserve family wealth into future generations, such as the "dynasty trust." A dynasty trust is a specially designed and implemented trust that contains family assets into perpetuity. The trust allows family members to use those assets and pay income to family members from those assets over subsequent generations. However, as the assets will be perpetually held in trust and never inherited, no estate or generation-skipping tax will be levied. Over a period of generations, it is not inconceivable that the value of the trust may have the potential to grow at a rate far in excess of the value of the assets had they simply been subjected to transfer taxes from one generation to the next.

Qualified Terminable Interest Property (QTIP)

Property transferred from one spouse to another upon death is generally not subject to estate tax because of the “marital deduction,” which is available for most property left to a surviving spouse who is a U.S. citizen. An unlimited deduction is allowed for a surviving spouse when property is transferred from the first to die, but it will be subject to the estate tax when that individual, the surviving spouse, dies.

You and your spouse must meet qualifications in order to get the marital deduction. One of the more significant qualifications is that taxpayers only get the unlimited marital deduction for property that passes to the surviving spouse without a “terminable interest.” A terminable interest occurs when the property passes to the surviving spouse with an ownership interest that terminates during the surviving spouse’s lifetime.

However, there is an exception to the terminable interest rule. This exception is known as Qualified Terminable Interest Property (QTIP). QTIP property must meet the following requirements:

- The property must pass from the decedent
- The surviving spouse must have a qualifying income interest for his or her entire lifetime, payable at least annually
- No person, including the surviving spouse, may have the power to distribute or appoint any part of the property to anyone other than the surviving spouse during his or her lifetime
- A QTIP election must be executed

So when a QTIP election is made for a trust,

- the surviving spouse will get the income for his or her remaining lifetime,
- the surviving spouse will include the asset in his or her taxable estate upon his or her death, and
- other named beneficiaries will inherit the asset upon the death of the surviving spouse.

If properly structured, there is no estate tax due on QTIP property when the first spouse dies, even though the surviving spouse may have inherited a terminable interest. QTIPs are often used in cases where there is a second marriage, and the family wants to preserve assets for the children from the initial marriage while providing income for the second surviving spouse and avoiding the payment of estate tax when the first of the couple dies. This strategy is typically sound. However, if the second spouse is very young (for example, the same age as the children from the initial marriage), this strategy may not be advisable. Remember QTIP property must provide the income interest in the QTIP asset for the spouse’s full lifetime before the transfer to the ultimate recipients. In this case, the younger second spouse may live as long or longer than the children from the initial marriage. And the children from the initial marriage will not get their inheritance until the younger spouse dies. In this case, the children from the initial marriage may never actually receive any inheritance.

QTIPs are also useful in situations where the surviving spouse may not be able to manage or control spending or lacks financial acumen. In anticipation of those circumstances, the first to die can provide for the comfort and continued income of the surviving spouse while, at the same time, protecting the corpus of the individual’s estate (i.e., dictating the ultimate inheritor or inheritors of the assets). No taxes are incurred upon the first spouse’s death.

QTIPs are also useful in situations where the surviving spouse may not be able to manage or control spending or lacks financial acumen.

Business owners have also used QTIP trusts to transfer ownership to the next generation while saving estate taxes. Here's one way that can work: The patriarch owner of a business makes lifetime gifts to his children of minority interests in the business, say 10 percent (5 percent to each of two children). The taxable value of these minority interests is discounted because of the lack of control and marketability. The owner retains 90 percent ownership, and sets up his will to bequeath half of his ownership (45 percent) to his spouse, and the other half (45 percent) into a QTIP trust. The children are the ultimate beneficiaries of the 45 percent held in the QTIP trust, and will inherit the remaining 45 percent ownership directly upon the death of the surviving spouse.

Because of the unlimited marital deduction, no estate tax is due when the owner dies. When the surviving spouse dies, the stock in the QTIP trust (45 percent) plus the stock bequeathed outright (another 45 percent), or a total of 90 percent, passes to the children. Minority ownership discounts may be separately applied against the spouse's outright 45 percent minority interest and the 45 percent QTIP minority interest, even though the combined ownership interest being passed on to the children does not represent a minority interest (90 percent).

The logic for separating the two 45 percent blocks for purposes of discounting the value is that the shares in the QTIP trust are not under the control of the surviving spouse. For example, the surviving spouse could not freely sell the QTIP shares. Therefore, the holdings are considered to be two entirely separate ownership blocks — and each of them is entitled to a minority discount.

But what if the spouse dies before the owner? Won't the owner then be stuck with a majority interest and no allowable discount? There is a simple solution to this problem: The owner and spouse simply split the ownership between each other while both are still living. In our example, the owner would make a lifetime gift of 45 percent to his spouse. This lifetime gift will not trigger any gift tax, because U.S. citizen spouses enjoy the unlimited deduction for lifetime gifts. Next, both spouses establish "mirror image" wills that set up a QTIP trust to hold the stock of the one who dies first. In this way, neither spouse will be left holding a majority stake outside the QTIP trust.

Charitable deduction for estate tax

As with the marital deduction, individuals may transfer assets to qualified charitable organizations without incurring estate or gift taxes. The tax code specifically spells out this estate and gift tax exemption for charitable giving. Further, qualified charitable gifts are deductible on the donor's individual income tax return, subject to certain limitations.

There are numerous tax-friendly alternatives for charitable gift-giving that use split-interest gifts (like charitable lead trusts, charitable remainder trusts, charitable remainder unitrusts, charitable gift annuities, or pooled-income funds). When properly structured, these gifts deliver full benefits to the charity along with tax savings to the donor and trust beneficiaries. Pick your tax benefits carefully, though. Although assets bequeathed to charity at death are not subject to estate taxes, the same assets if gifted to charity during your lifetime would result in a double benefit — a current income tax deduction as well as removal from your estate.

Twelve-month extension to pay estate tax (IRS Code Section 6161)

Ordinarily, inheritors must pay an estate tax bill within nine months after death. The estate can request a twelve-month extension to pay the tax (under Section 6161) if the executor can show "reasonable cause" for it. The IRS will charge interest during the extension period at the regular floating rate as periodically published and prescribed by the tax code.

In this context, what are some examples of "reasonable cause"?

- The assets of the estate are located in several states and require additional time to administer
- The assets of the estate include receivables that must be collected
- The assets of the estate are subject to litigation or dispute
- The current composition of the estate does not provide the liquidity to pay, and additional time is needed to liquidate assets to pay the tax

If the IRS grants an extension, it may require the posting of a bond, generally for an amount exceeding twice the estimated estate tax due.



Installment payments of estate taxes (IRS Code Section 6166)

If the value of a closely held business makes up more than 35 percent of the “adjusted gross estate” for purposes of calculating the estate tax, the executor can elect to pay the estate taxes resulting from the closely held business over a span of 10 years. The estate tax payments must begin no later than the fifth year following the original due date of the estate tax, which is nine months from the date of death. The IRS will charge interest during the extension and installment period at 45 percent of the regular floating rate as periodically published and prescribed by the tax code.

For this purpose, Section 6166 defines a closely held business as:

- An interest in a sole proprietorship
- An interest in a partnership carrying on a trade or business if (1) 20 percent or more of the partnership capital interest is included in the gross estate or (2) the partnership has 45 or fewer partners
- Stock in a corporation carrying on a trade or business if (1) 20 percent or more of the voting stock is included in the gross estate or (2) such corporation has 45 or fewer shareholders

The measurement date in making the above determinations shall be as of the time immediately before the decedent’s death. Special rules apply to holding companies, lifetime gifts, and businesses held by closely related parties.

Stock redemptions (IRS Code Section 303)

IRS Section 303 allows the estate of a closely held business owner to sell stock back to the corporation with preferential income tax treatment. Such a redemption usually produces little or no income tax because the estate’s income tax basis in the redeemed stock was “stepped up” as of the owner’s death. Under Section 303, if the fair market value of the stock is greater than the estate’s “stepped-up” basis, the gain is afforded preferable capital gain treatment, rather than ordinary income treatment.

Why is this significant? Without the Section 303 provision, a partial redemption of stock could be classified as a dividend, subjecting the full amount of the distribution (without offset from basis) to qualified dividend income tax rates.

This dividend classification would be taxed at a rate of 15 percent for married filers earning less than \$450,000 or single filers earning less than \$400,000. For joint filers earning above \$450,000 or single filers earning above \$400,000, the rate would be 20 percent. In addition, this dividend could be subject to a surtax on net investment income at a rate of 3.8 percent. The 3.8 percent surtax applies to the lesser of the taxpayer’s net investment income (after investment related allowable deductions) or modified adjusted gross income (“AGI”) for those joint filers with adjusted gross income over \$250,000 or single filers with adjusted gross income over \$200,000.

To qualify for Section 303 treatment, the value of the stock in the closely held company must exceed 35 percent of the decedent’s entire adjusted gross estate. The allowable amount of Section 303 redemptions is limited to the sum of the following:

- Federal estate taxes paid, including interest
- State inheritance taxes paid, including interest
- Funeral and administrative expenses allowed as deductions against the estate tax

For Section 303 redemption to succeed, the company needs cash to redeem the stock from the decedent’s estate. One way to provide the needed cash to execute a redemption is through the use of life insurance.

In this scenario, the company buys a policy on the life of the owner and names the company as the beneficiary. If the owner dies, the company receives the death benefit to fund the Section 303 redemption. But remember, if the business owner is older or in poor health, the life insurance may be prohibitively expensive. In such a case, Section 303 redemption may not be the best estate-tax planning solution.

These are some of the most common estate-tax planning approaches, but not the only ones. It is important to remember that succession planning is a stage on which many different disciplines have to interact. When they’re in tune, it’s easier to save estate and income taxes, preserve family wealth, protect shareholders and employees, encourage business success, and promote family harmony.

Life insurance planning

Life insurance is a basic tool to manage the risk of loss and can effectively provide income replacement for a family or business upon the death of a wage earner or key employee. For closely held-business owners, proceeds from life insurance policies may be used to purchase the stock of a deceased shareholder of the company in order to facilitate the transfer of the business from one generation to the next. Life insurance proceeds may also be used to pay estate taxes, and, from an income tax standpoint, a life insurance policy offers several potential benefits:

- Assets can enjoy tax-deferred build-up
- Tax-free withdrawals are allowed up to the amount of investment in the contract in certain circumstances
- Assets may be used as security for a loan from the insurance company without incurring tax on the incurrence of the debt
- Death benefits are generally not subject to income tax

Types of insurance

Despite the complexity associated with life insurance products, there are fundamentally only two types of insurance: term life and whole life. Other insurance offerings such as universal life, variable life, renewable term, term/whole life mix, or second-to-die policies are combinations, enhancements, or variations of the two basic types.

Term insurance

Term insurance provides life insurance coverage for a limited period of time, or term. There are basically two elements to a simple term policy: the cost of the policy usually stated in terms of the periodic premium payments, and the death benefit. The premiums are payable during the term of the life insurance coverage. If the insured dies during the term, the policy pays the stated death benefit to the beneficiaries named in the policy. If the insured outlives the term of the policy, no death benefit is paid and there is no return of premiums.

There are three types of term insurance:

- Annual renewable term
- Level term
- Decreasing term

With annual renewable term insurance, the attendant cost of the coverage goes up as the insured ages. Level term locks in the cost for a period of 5, 10, 15, or 20 years. At the end of each period, the cost increases dramatically. The cost remains fixed at the new level until the end of the next period, when it increases again. Decreasing term is the opposite of annual renewable term. The annual cost of the insurance stays the same going into the future, but the death benefit is reduced.

Despite all the complexity associated with life insurance products, there are fundamentally only two types of insurance: term life and whole life.

The biggest advantage of term insurance is cost. Generally, term insurance is the least expensive way to provide relatively short-term coverage. Term insurance can also be canceled by simply not paying the premium. This is an advantage because sometimes changes in circumstances impact the usefulness of a life insurance policy. Because there is no cash value or return of premium to consider with term insurance, obsolete term policies may be allowed to simply lapse.

However, the biggest disadvantage of term insurance is also cost. Term insurance premiums increase with the age of the insured. While term coverage provides comparatively inexpensive coverage over a stated term, the cost to renew the policy after the original term has expired may be very expensive. It is possible that the insurer may decline to renew the term policy, and the insured will be unable to find coverage at any cost.

A variation on basic term insurance is called "Renewable Term" insurance. These term policies are automatically renewable at the end of the original term. These policies are especially valuable to an insured who has developed health difficulties which would negatively impact the ability to obtain new insurance. However, insurance companies charge more for this feature, and the premiums become much more costly as time passes.

Some term policies have a provision allowing the insured to convert the term insurance into some form of whole life insurance. This feature serves as a hedge against the chance that medical complications will affect the insured's ability to find additional coverage at the end of the term policy.

Group term insurance plans are among the most popular employee fringe benefits offered by employers to their employees. The company purchases term insurance for all employees as a fringe benefit. The employees name their own individual beneficiaries on the insurance. The company is allowed a tax deduction for the premium payments, and the employees may exclude the first \$50,000 of coverage under the plan from taxable income. The value of coverage in excess of \$50,000, if paid for by the employer, is calculated and added to the employee's wages for the year, and reported on the employee's Form W-2, subject to payroll taxes. Qualified group term insurance plans cannot be designed to discriminate in favor of highly compensated employees.

Whole life

Whole life insurance evolved as a solution to the difficulties relating to the renewal of term policies, as described in the previous section. Remember, after a term policy expires, the insured may find that (s)he is unable to find additional coverage at any price, due to advanced age and medical conditions. Whole life, or permanent insurance, was designed to address this problem.

With a whole life policy, the insured is guaranteed coverage and the whole life premium payments are structured in a fixed series of equal payments. As long as the premium payments are made, the insurer cannot cancel the policy. To accomplish this benefit, a portion of each payment is placed in a fund, which will serve to reduce or amortize the financial obligation. Over the years, this fund grows in value and is referred to as the policy "cash value." The insurance company may use the fund to make up any shortfall between the annual cost of the insurance coverage and the annual premium payment required.

With traditional whole life insurance, the fund earns a guaranteed, conservative rate of return. Although this amount grows on a tax-deferred basis, the performance may be disappointing in a high-inflation environment or where better returns are otherwise available through other investment vehicles.

Typically, holders of whole life policies can borrow against the cash value of their policies. These loans are very easy to accomplish, the repayment terms are flexible, and the cash can be accessed quickly. However, the interest is not deductible for income tax purposes by individuals, and is deductible in only a very limited set of circumstances by business owners.

A whole life policy can be cashed in with the insurance company at any time. After the owner receives the cash, the policy is simply cancelled. The cancellation of a whole life insurance policy is typically a taxable event. Losses on the cancellation of a whole life policy are not typically deductible for individuals, although they may be in the case of a business-owned policy.

Universal life

Universal life is a variation of traditional whole life insurance. The universal life concept came about to address consumer dissatisfaction with the conservative, guaranteed rates of return provided by the traditional whole life fund. In the early and mid-1970's, people figured out they could cancel their whole life policies, buy cheaper term insurance, and invest the premium savings in other investment vehicles that significantly outperformed the guaranteed rates provided in the whole life funds and, in so doing, create an individualized fund that could pay a much higher return.

To counter this exodus from the traditional whole life insurance product, insurance companies developed universal life. Universal life policies work just like whole life policies in that the insured's policy cannot be cancelled by the insurance company and a portion of each premium payment is placed in a fund with a guaranteed minimum return. The difference is that with universal life, as market rates of interest increase, the policyholder will similarly achieve a higher return on its fund, and depending on its contract, a higher death benefit. The "downside," of course, is if market rates go down, the return to the policyholder, and potentially the death benefits under the contract, will similarly decrease.

Variable life

The third type of permanent insurance is called variable life. It was developed to try to improve on the shortcomings of both whole life and universal life policies. This type of policy allows the insured to direct the insurance company to invest the fund cash into mutual funds or money market accounts. As long as the investments perform well, the insured does very well with this arrangement, outpacing the more conservative other whole life policies. At the same time, however, the policyholder is also taking on the potential downside risk of the selected investments.

Term/whole life mix

A popular strategy is to purchase a mix of term insurance and whole life insurance. In this situation, the term policies provide the greatest death benefit for the least premium in the short run, while the whole life policies provide insurance coverage with a steady, predictable premium that cannot be canceled in the long run. This mix allows a whole life product to be competitive in price with universal life prices by, for example, using potential policyholder

dividends to acquire additional guaranteed insurance — referred to as paid-up additions. If the investment rate of return is as predicted, the term/whole life mix will be able to sustain a targeted cash value at a lower premium than straight whole life.

Life insurance is almost always a consideration when developing a succession plan. Moreover, as new succession alternatives are developed, old insurance needs may become obsolete, while new insurance needs may arise. The following discussion of various insurance alternatives illustrates some of the different roles that life insurance may play in succession planning.

Income replacement

The primary reason that many people buy life insurance is as a replacement for income streams from deceased wage earners who supported their families. This need is sometimes overlooked by such wage earners who were business owners when planning for succession. This is because many owners plan to bequeath the business to their family members and assume the family members will continue to reap the same cash flow from the business after death. This reasoning does not account for the fact the family will lose the income stream from the deceased's salary. That salary must now go to someone else who is now performing the duties of the deceased. If the replacement employee is not a family member, the cash flow provided by that salary is no longer family income.

Estate tax liquidity

As discussed earlier in this volume, life insurance is a widely used financial tool for paying estate taxes upon death. Often, the estates of closely held business owners are comprised significantly of illiquid property. This may cause a severe liquidity crunch when the estate tax comes due. Insurance policies on the lives of the business owners may provide the liquidity needed to help pay estate taxes.

Key person insurance

Key person insurance provides businesses with protection in case one of the key employees dies. The business generally makes the premium payments, and is the beneficiary of the policy. The premium payments are not deductible for income tax purposes, and the death benefit is generally excluded from taxable income of the business. Exceptions may exist for companies subject to the alternative minimum tax.

Key person insurance proceeds may help a company transition through the financial and other difficulties that might occur when a key executive dies. Bank loans can be paid down. A stronger balance sheet (with cash reserves and less debt) can help creditors, customers, shareholders, and employees feel more secure in the ability of the company to remain viable. If sales decline temporarily, the company will have additional cash reserves to continue through the rough times. Finally, the insurance proceeds may be used to help recruit and train the deceased executive's successor.

Funding a buy-sell agreement

The death of a closely held business owner is often a triggering event in a company's buy-sell agreement that mandates the purchase of the deceased owner's shares by the company or the other shareholders. Life insurance is commonly used as the funding source to pay for such a purchase. Typically, buy-sell agreements are designed as either redemption agreements (the company buys the stock from the deceased shareholder's estate) or cross-purchase agreements (the other shareholders buy the stock from the deceased shareholder's estate). If the buy-sell calls for a redemption, the company may consider purchasing adequate life insurance coverage on the lives of all the shareholders. If one of the shareholders dies, the proceeds from the life insurance policy may be used by the company to purchase the stock from the deceased shareholder's estate. If the buy-sell agreement calls for a cross-purchase, all of the shareholders may buy insurance policies on the lives of all the other shareholders. In the event of the death of any one of the shareholders, the surviving shareholders may use the proceeds from the life insurance to buy the stock personally from the deceased shareholder's estate.

Compensation

Life insurance can also be used to enhance employee compensation packages. A common example of such a strategy is accomplished by setting up a split-dollar life insurance plan. In a split-dollar arrangement, the employer and employee split the cost of the life insurance premiums on the employee's life. Upon the death of the insured, the company receives back what it effectively paid for the policy and the employee's beneficiary receives the portion of the death benefit in excess of the amount returned to the employer.

Life insurance is also commonly used to fund nonqualified deferred compensation plans. Although nonqualified deferred compensation plans do not have to be structured with life insurance, employees find it reassuring when their plan benefits are reinforced by the existence of a life insurance policy. Typically, the company will buy an insurance policy on the life of the employee, naming the company as the beneficiary. If the employee dies before retirement age, the insurance death benefit is used by the company to pay the obligation under the nonqualified deferred compensation to the deceased employee's heirs. If the employee lives to retirement age and cashes out the balance in the nonqualified deferred compensation plan, the company can use the cash value in the policy to help fund the obligation to the employee under the plan.

The life insurance policy review

It is advisable that your succession planning advisors include independent insurance advisors. They work with your insurance agent to coordinate the right mix of insurance products with the technical recommendations to be implemented to help business owners and individuals avoid common insurance problems.

Periodic examination of insurance policies is prudent as family and business situations change. Possible unaddressed insurance issues include:

- Children and grandchildren are born, married, and divorced, requiring insurance restructuring
- Beneficiary designations may not be current
- Beneficiaries on policies sometimes predecease donors; therefore, policy ownership may not be structured in the most tax-effective manner
- Ancillary documents (such as split-dollar agreements or buy-sell agreements) may not be properly in place
- The current mix of insurance products may be inappropriate or overly expensive

Investment strategy

As a business owner, you face special challenges when it comes to managing family wealth. It takes so much time and energy to stay on top of business operations that it seems there's little bandwidth left to manage personal investments. So you may defer investment decisions to a broker or money manager. Experienced help definitely has its benefits, but your personal attention is still a necessary ingredient for your investment portfolio to reach its potential. No one knows better than you how to make sure your investment strategy aligns with your family's goals or those of the business.

Investment diversity also presents a special challenge for closely held business owners. Growing a business requires capital. During periods of growth, many business owners answer part of the need for capital by reinvesting their profits in the company. If that sounds familiar to you, that concentration may keep you from accumulating the kind of large, diversified personal investment portfolio most investors try to build. That means investment planning ends up relatively low on your list of priorities — and that you have fewer options to plan around in the first place.

Coordinating succession planning, investment planning, and monitoring

Managing wealth should be integral part of any comprehensive succession planning process. To successfully anticipate and plan for future needs, investment advisors must understand their clients' attitudes and competencies:

- Overall investment goals and objectives
- Personal risk tolerance
- Level of knowledge relating to investing
- Current investment strategy
- Current investment portfolio

To offer effective counsel in a succession situation, investment advisors must also have a clear command of these important issues:

- The tax ramifications of the technical aspects of the succession plan
- The practical and financial ramifications of the technical aspects of the succession plan
- Short-term and long-term individual liquidity needs
- Possible future business concerns, such as financing or capital obligations

- Estate planning and birthright issues between heirs working in the business and heirs working outside the business
- The founder's retirement plan, estate plan, insurance needs, and income tax situation

This information may have a direct effect on investment decisions. That's because misunderstood tax issues or unanticipated cash needs can certainly derail investment strategies. Based on these factors, a sound investment consulting process should generally entail four basic steps:

Assessment

The investment advisor will assess the current portfolio, investment strategy, and risk tolerance, then provide education on investment principles and on how an investment plan can relate to specific financial goals. When assessing the investment needs of the business owner, the investment advisory specialist should work to understand and account for all of the elements of the comprehensive succession plan.

Analysis and recommendations

The investment advisor will develop asset allocation models and help draft an investment policy statement.

Implementation

The investment advisor will provide information on money managers, and will help identify money managers who are ready to work within the bounds of the investment policy statement developed in the analysis and recommendation phase.

Monitoring

On a periodic basis, detailed summaries of portfolio holdings and transactions, portfolio performance reports, and ongoing supervision of investment policy should be provided.

An investment advisor who understands all of the components of the succession plan may better account for income and estate tax complications, retirement needs, or other special cash requirements. The hope for every retiring business owner is to experience seamless coordination of the plan by an investment advisor who is independent, tax sensitive, and understands the succession plan.

Conclusion

Neither succession planning nor retirement planning happens quickly. You've probably spent years preparing for both. If you're like many business owners, though, you have a penchant for putting the needs of the business ahead of your own. That may have meant prioritizing daily operations and eventual succession over securing your own wealth. Besides, it's human nature to put off such things — and in that respect, owners are no less human than their employees.

The future of the company and your future personal finances are closely intertwined. They'll remain linked even after your last day on the job. But intertwined doesn't mean identical. It's time to give full, distinct attention to preserving and enjoying the rewards you've spent a career earning.

On any given day, a personnel decision or a supplier contract or any of a thousand other things can alter your priorities and persuade you to leave long-term decisions until tomorrow. In financial planning as in business, don't let the urgent crowd out the important.

Everyone plans for retirement, but the process is different for business owners. You can and should rely on professional counsel for both the succession process and the retirement process. You should certainly insist that the advisors you use in each case pay attention to the other side of the equation and work toward alignment. But the ultimate responsibility for making it all work rests with you.

The details are profound, the pitfalls many. But you've faced those odds before. It's how you got here. This is the time to see it through.



Case study

The following scenario is based upon experience with actual family businesses. It is intended to illustrate the importance of paying attention to the nuances of tax, insurance, and estate law.

Two businesses, two different planning outcomes

The two businesses grew side by side for decades — a restaurant and a hair salon. Both had started as family affairs, but over time they had each brought in more non-family members, first as employees and eventually into management roles. The restaurant added two locations and the salon expanded into a full-service day spa. Their owners were old friends and sometimes stopped to talk shop with each other. Now, retirement drew near for both.

Carmen couldn't believe he was soon going to be going to bed and getting up at "civilian" hours without having to meet delivery trucks, micromanage a kitchen, greet patrons, and handle the books. He knew better than to buy into his friends' exclamations that the restaurant "must be a gold mine!" but he had managed things carefully over the years. He knew there was enough to carry him and his wife through retirement and to give his children a sound legacy.

Alicia never had to work the crazy hours Carmen did, but she'd always been the face of the salon and seldom took real vacations. Even in retirement she planned to remain a fixture in town. But she had her eye on a property adjacent to hers, and plans for a bigger home where she could sculpt, host big family holidays, and maybe put in a pool.

Only two years into his retirement, Carmen unexpectedly died. His wife took comfort in knowing he'd made plans to provide for her. The first surprise came when Carmen's life insurance policy paid out: Because the policy had been under Carmen's ownership, it was taxed at the 40 percent federal estate tax immediately. His wife was left the sole

proprietor of a thriving business, but its assets were mostly illiquid. Meanwhile, the sums Carmen had bequeathed to his children weren't protected from estate tax through any trusts or other structures, and because of tax rate changes over time, they were also taxed and lost a lot of their value. Carmen's widow will be able to support herself, but to do so she faces a hard choice: either sell the restaurant — or take over Carmen's old podium at the front of the house every night.

Alicia has made planned annual gifts to her children and grandchildren that fall within allowable limits. She has also structured trusts for the grandchildren that will activate upon her death. She named her brother and a local law firm as co-administrators of the trusts, so her heirs will have the benefits of both family involvement and institutional permanence. This will prove sadly prescient when her brother dies before some of the grandchildren reach majority. And while much of the capital she received upon selling spa and salon to a regional chain has been sunk into her real estate dreams, she has also used it to fund a balanced, well-structured portfolio of more flexible investments, including stock in the company that bought her out.

Both Carmen and Alicia planned for retirement and succession with all the diligence they'd brought to building their businesses. The difference between their families' experiences had nothing to do with effort or care — it had everything to do with attention to the nuances of tax, insurance, and estate law. What both families learned in the end was that the fine print looms large.



This is the fourth volume in our Business Succession Planning series.
Prior volumes are available for download at www.deloitte.com/us/dges/BusinessSuccessionPlanning.

