ISSUE 01

SUCCESSION PLANNING – A VIEW FROM THE TOP

The first step in navigating the issues and challenges for creating and implementing a successful succession plan.

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SUCCESSION PLANNING – A VIEW FROM THE TOP

SUCCESSFUL SUCCESSION

Every family is unique. Unique in their relationships, their issues, their challenges and their goals and desires. However, among this uniqueness, we do find a number of commonalities. One commonality is the struggle to create and implement a successful succession plan. We suggest that adopting ideas and approaches used by other families is a way to assist in creating a successful succession plan for your family.

Succession planning is often thought of as passing on the ownership and control of a business, whereas estate planning is often used in the context of a family. We believe each of these terms is too narrow and that succession planning applies to a family rather than simply to a business. Although one generation of a family is passing on wealth and assets, it is also passing on much more, including: goals and wishes; responsibility and decision-making; non-charitable and charitable legacies; and often operating businesses.

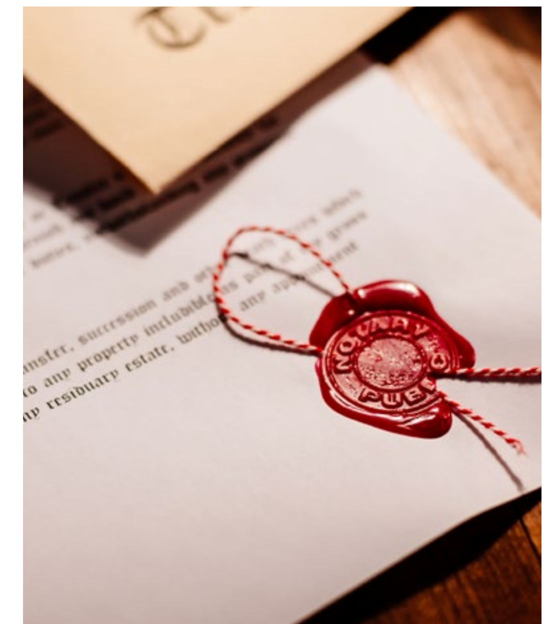
No matter what you call it, we find families everywhere struggle to comprehensively address succession issues despite teams of advisors, including lawyers, accountants, psychologists and even Next Gen advisors. Unfortunately, the outcome is less than optimal with proposed solutions that are uncoordinated, overly complex, or focused only on a narrow segment of the broader issue.

In our work we find that the most successful plans apply a clear and comprehensive approach that brings all parties to the table. Most important to all is open communication. To cross the wealth transfer bridge successfully, we suggest a three part approach: Part 1 addresses the challenges faced by the senior generation (generation 1); Part 2 addresses the challenges faced by the junior generation (generation 2 and beyond); and Part 3 is developing a plan to bridge the generations.

This framework can be used to begin, update or stress test a plan and will hopefully broaden thinking and provide greater context for these important issues. To assist in the process, we will prepare four white papers as a guide. The papers will follow the framework highlighted above (senior generation, junior generation and plan development) and a fourth paper that addresses issues relevant in planning with "unique" assets. As the first paper in this series, our focus here will be on the senior generation.

CORE ISSUES FOR THE SENIOR GENERATION

In our work with families, we find that the senior generation is often concerned with two main issues—balancing wealth transfer without creating disincentives and protecting beneficiaries and the wealth transferred to them (from themselves, creditors, divorce, opportunists, etc.). Addressing these issues is core to any successful plan.



How Do I Transfer Wealth Without Creating Disincentives?

The core of any succession plan is making gifts (i.e., transferring assets). However, we frequently hear, "I do not want to create trust fund babies!" To address this concern, it is important to understand the tools and techniques, and pros and cons, associated with different wealth transfer strategies.

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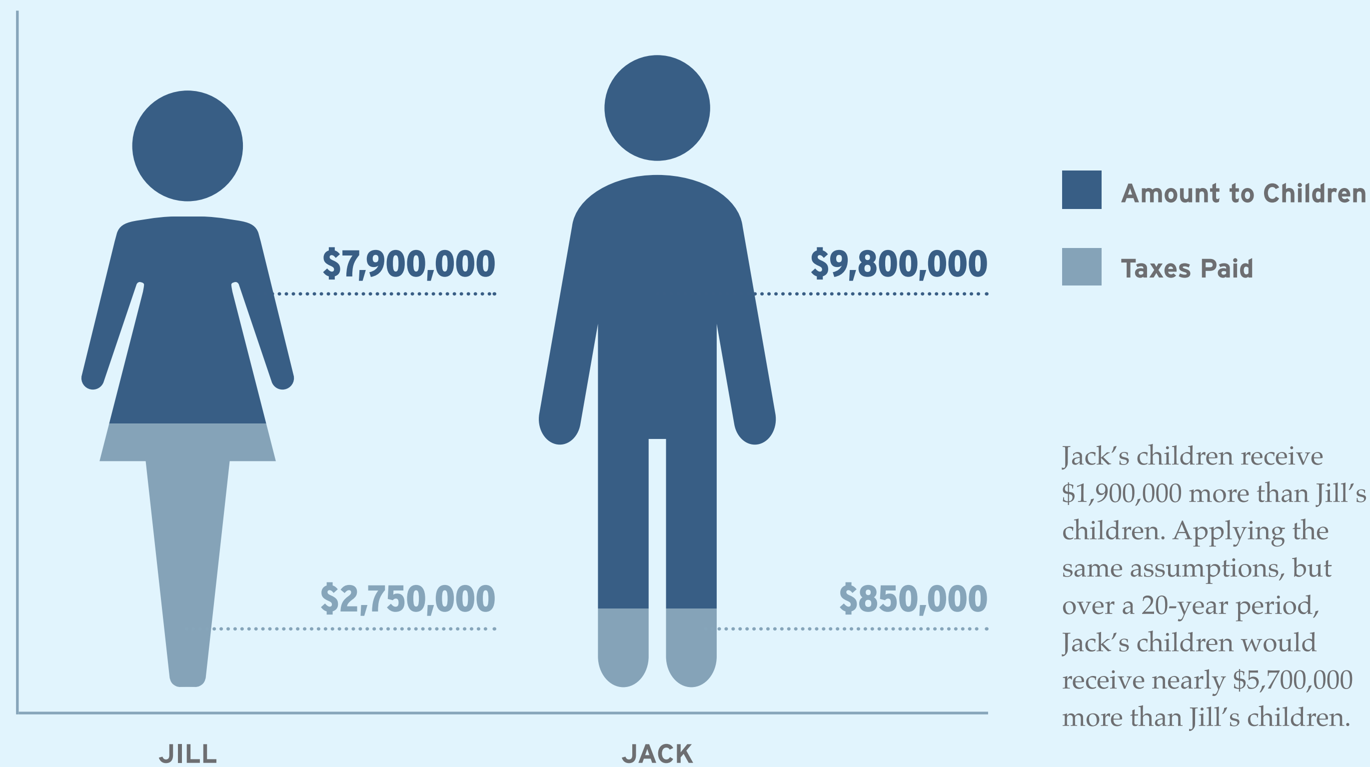
CASE STUDY

THE VALUE OF GIFTING APPRECIATION

Jill and Jack have both earmarked $5,000,000 that will go to their respective children. Jill's transfer will not occur until she passes away whereas Jack will make the gift today in trust for the benefit of his children. Assuming everything else being equal and that Jill passes away in year 10, the amount passing to Jack's children is nearly $2,000,000 more than the amount passing to Jill's children.[1]



Jack's children receive $1,900,000 more than Jill's children. Applying the same assumptions, but over a 20-year period, Jack's children would receive nearly $5,700,000 more than Jill's children.

[1] *Assumes for both scenarios that investments return 7% per annum and that the same income tax rates apply. Also assumes the trust established by Jack is a grantor trust and therefore he pays all the income tax associated with the trust's income and gains. For illustration purposes only. As with any investment, there is the risk of loss.*

Outright Gifts vs. Gifts In Trust

Outright gifts instill a sense of ownership and responsibility in the recipient. They tell the recipient that you have unconditional faith in their judgment and ability. Such gifts are relatively simple to make and do not require complex structures. However, outright gifts are also a complete relinquishment of control, expose the gifts to potential creditors, and might not be the most tax efficient means to transfer wealth.

An alternative to outright gifts is to make gifts in trust. In our experience the benefits of this route outweigh the negatives. Yes, it is often more costly to make these types of gifts as they require the creation of trusts (and possibly other structures). Fiduciaries, including trustees, have to be named and many other aspects that may not have relevance until many years down the road have to be thought through. However, most clients find the benefits of control, protection, and tax efficiency outweigh these hassles. Gifts in trust can provide the retention of control through specific trust terms or trustee instructions. Assets can be protected from creditors. Particular investment opportunities can be utilized as well as more tax-efficient vehicles. Many clients will use trusts as financial educational vehicles for beneficiaries. Additionally, properly structured trusts can limit the amount any one beneficiary might receive, while maintaining sufficient flexibility to address potential unforeseen future needs.

Gifting Today vs. In The Future

Whether assets are passed in trust or outright, often the next question is, "When should I pass assets? Today? Or sometime in the future?" There is no right or wrong answer here and we often see a combination of current and future gifts. Both have possible benefits and detriments.

Current gifts have the benefit of removing future appreciation from the transferor's estate and provide immediate enjoyment by beneficiaries. In addition, a current gift might be timed with an event such as the start of a business, the purchase of an asset that might be advantageous for estate planning purposes, or made in advance of an adverse change in tax law.[2] However, current gifts might also be detrimental. For example, if the transferor needs the assets in the future he or she might not have access to them, or the transferor might lose desired control over the assets. Another common issue is the concern that a beneficiary's knowledge of a trust might act as a disincentive to work or pursue a career. In addition, where exemption from gift tax will be used to shelter a gift, consideration should be given to whether current use of the exemption is optimal.

The benefits and detriments of future gifts are almost the opposite of current gifts. Benefits include retained use and control of the assets by the transferor, avoiding the creation of a "disincentive fund" and the grantor's retention of the gift exemption for future use. The detriments include having future appreciation included in the grantor's estate increasing future estate taxes, foregoing the opportunity to transfer an asset at an optimal time such as the start of a business or the purchase of real estate, and foregoing taking advantage of current favorable tax laws.

Many of the concerns with making current gifts can be alleviated through careful structuring of the gifts and trust terms. Possible techniques will be discussed in more detail in the following sections of this paper along with a discussion in our third white paper, "Creating an Optimal Plan."

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Techniques To Help Avoid Creating "Trust Fund Babies"

Incentive And Disincentive Clauses

A major concern we often hear is that establishing a trust will cause the beneficiaries to lose the drive they might otherwise have—that the trust will be viewed as a "personal piggy bank." To help alleviate these concerns, many clients will utilize "incentive" or "goal achievement" clauses in trusts. These clauses provide both the trustee and the beneficiaries with a framework that rewards productive and responsible behavior (and can also be used to "discourage" unproductive or irresponsible behavior). For example, clauses can provide that distributions will be made upon graduating from college or graduate school, upon achieving certain accolades or goals, or upon pursuing a career that benefits society. Likewise, clauses tying future distribution amounts to specific achievements are also popular. Such clauses can match a salary or provide specific dollar amounts upon the achievement of certain milestones. In addition, "life event" distributions for items such as purchasing a first home, getting married, having a child, etc., are also popular.

In this same vein, "disincentive" clauses can also be considered. These clauses provide for the limiting or holding back distributions for "bad behavior." Items such as drug habits, alcoholism or gambling are frequent grounds for withholding distributions. Distributions might also be held back during a marital separation or divorce proceeding. Note, as with all clauses, close attention to details is especially important here. You might consider a clause that holds back distributions if the beneficiary has a drug habit. However, such a clause can lead to a "rabbit hole" of decisions such as how is a "drug problem" defined and determined, can funds be used to help with treatment, etc.? In addition, certain provisions might be unenforceable as void against public policy depending on state law and the nature of the provision (such as limiting distributions based on the race of one's spouse). Like incentive clauses, disincentive clauses should be carefully thought out as they might lead to unintended consequences.

"Silent" Trusts

It is not unusual for a parent to establish and fund a trust when a beneficiary is very young (or perhaps not yet born). Often parents do not feel their children are ready to be informed of the existence of trusts for their benefit, and that such knowledge will create disincentives. Most state statutes require some form of notification of a trust to be supplied to a beneficiary. These notifications, depending on state law, might vary from just giving notice of a trust to full financial disclosure. One option that addresses this issue is to select a jurisdiction where the trust can be "silent." Some jurisdictions, such as Delaware[3], allow for delayed notification to a beneficiary, with such delay possibly for a significant number of years. Often, these states will require someone to receive notice on behalf of the beneficiary; however, that person can often be appointed by the grantor and could be a friend, family member, or other person.

"Directed" Trusts

Another tool to help maintain control and combat the issue of disincentivizing beneficiaries is using directed trusts. In directed trusts, the appointed trustee is limited in the responsibilities the trustee can exercise, generally restricted to administrative services only. Other aspects, such as controlling investments and distributions, are handled by "advisors" that are appointed by the grantor. These advisors direct the

CASE STUDY

THE UNINTENDED CONSEQUENCE OF A POORLY DRAFTED DISINCENTIVE CLAUSE

Jack is worried that his son Bobby, who has an alcohol and drug problem, will squander assets. Jack drafts into his trust, "the trustee shall not make distributions to the beneficiary where the trustee believes that the beneficiary will use such distributions in furtherance of a drug or alcohol habit. In addition, the trustee shall not make distributions to the beneficiary where the beneficiary is using illegal drugs or alcohol." Years later, Bobby has chronic liver failure and is in need of a liver transplant. The trustee knows Bobby is an alcoholic (and is also using illegal drugs). Should the trustee make a distribution to Bobby? How about if the distribution was to pay for the liver transplant needed because of the damage done as a result of Bobby's drinking? Depending on how the prohibition language was drafted the trustee might not be able to make a distribution.

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trustee to execute on their advice. The trustee does not have the discretion to execute or not execute and generally has to follow the direction of the advisors.

With directed trusts, it is typical for the grantor to retain investment control as the investment advisor. This provides the grantor with some continued control over the trust and allows the grantor to determine the best use of trust assets as it pertains to investments. Although it is common for the grantor to hold this power, consideration must be given to potential estate tax and income tax consequences that may be caused by the grantor having such power.

For distributions decisions it is generally not advisable for the grantor to retain such powers. Retaining such powers might create adverse estate tax consequences. Instead, such powers should be held by a family member, friend, or professional advisor who is intimately familiar with the grantor and the grantor's family.[4] Often the grantor will provide written and unwritten guidance to the distribution advisor regarding the grantor's intentions, wishes, and goals. The use of a distribution advisor allows a person to act for distribution purposes without burdening them with (and making them possibly liable for) the full responsibility of a trustee. A distribution advisor is useful when the grantor is purposefully vague or relies on the intimate knowledge that the person making distributions has. However, often professional trustees and corporate trustees will lack such knowledge of the grantor and/or the grantor's wishes or have little understanding of the beneficiaries. In such situations, a distribution advisor who has intimate knowledge of the grantor's wishes and has a closer relationship to the beneficiaries might be a good fit.

How Do I Protect My Beneficiaries And The Wealth I Transfer?

As common as the concern of creating disincentives is how to protect wealth that is passed to beneficiaries. How can transferred assets be protected from a future divorce, lawsuits, or other legal liability? How can beneficiaries be protected from those who might seek to take advantage of them? There are a number of techniques available to help protect assets.

Using Trusts

The simplest and perhaps most powerful tool to protect assets is to have assets transferred in trust for beneficiaries as opposed to being transferred outright. A properly structured trust can protect assets from divorce, creditors, and other liabilities of a beneficiary.[5] In addition, trusts can help create barriers to those who might try to take advantage of beneficiaries. This protection can be achieved while still providing beneficiaries with significant access to trust assets.

CASE STUDY

THE DIVORCE-PROTECTED HOUSE

Susan, the beneficiary of a trust, was seeking a distribution from a trust to purchase a vacation residence. Although within the power of the trustee to make such a distribution, the trustee, knowing that Susan's marriage was on shaky ground, convinced Susan to have the trust buy the house for her use. A few years later, Susan got divorced. Although there was no guarantee under state law, if Susan had taken funds out of the trust and purchased the house it likely would not have been an asset subject to divorce settlement. However, since the trust owned the house, there was no question that the house was not part of the divorce settlement. Susan's ex-husband's divorce counsel even recognized the extra protection by indicating that if the house was owned in Susan's individual name, he would have tried to pull it into the divorce estate. The fact that it was owned by the trust made it "untouchable."

Using Other Transfer Vehicles

Another alternative to outright gifts of assets is gifting interests in closely held and controlled entities, such as limited liability companies (LLCs) or partnerships. For example, instead of transferring $1,000,000 of stocks to a child, a parent could create and fund an LLC with stock and then transfer an interest in the LLC to the child. This technique can provide several protective features. Unlike when assets such as stock, cash, or even real estate, are held outright, interest in such an LLC is less attractive to a creditor or spouse seeking divorce. Assuming the LLC is properly structured, interests in the LLC will be subject to various restrictions regarding use, liquidation, distribution, and control. Therefore, although not an "absolute shield" from liability, LLCs may create a negotiating position with creditors as much less attractive assets. In addition, depending on what state the LLC was created in, it might not be attachable by a creditor or, at best, a creditor might get a charging order against the LLC interest (i.e., a right of garnishment against distributions from the LLC)—a very unattractive position to be in.

In addition to the protection benefits entity structured gifts can afford, other benefits might be achieved. Such benefits include retained control over the assets by the senior generation, creation of a family investment entity, economies of scale, and gift and estate tax benefits.

A common vehicle to make gifts to minors is to use a custodial account such as a Uniform Gift to Minors Act account (UGMA) or Uniform Transfer to Minors Act account (UTMA account). These accounts hold gifts for the benefit of a minor with assets controlled, for both investment and use, by a custodian (usually a parent or the donor) until the minor reaches the age of majority or another age specified under state statute (age of mandatory distribution). Although these accounts protect the assets from the child's creditors and provide for control over access and use, they do have one significant downside—the protection (and control) only lasts until the child reaches the age of mandatory distribution. At the attainment of that age the assets become the child's free and clear and subject to the creditors of the child at that time and going forward.

We often see situations where custodial accounts were created and funded when a child or grandchild was very young. The mandatory age of distribution was a long way off so no one thought ahead at the time of funding. However, as all of us with children know, children grow up fast. Months, weeks, or even days before a distribution from a custodial account is required to be made, the custodian contacts the parents, and the parents, in a panic, want to know what they can do to further delay distributions to their child. Unfortunately, under state laws, once a beneficiary reaches the age of distribution, the custodian is required to give notice and the beneficiary receives unfettered access to the assets. In addition, transfer of custodial assets shortly before a beneficiary reaches distribution age (or technically at any time after a custodial account is established) has to be restricted by law to give the child full access and control over the assets upon reaching distribution age. Therefore, transferring custodial assets to a trust (or entity or otherwise restricting the assets) will not work to create continued asset protection or control. Where custodial accounts are being considered, we often suggest considering creating a trust to receive such gifts instead of a custodial account.

A rarely thought of, but beneficial, planning technique is establishing a retirement account for a minor. Retirement accounts, such as IRAs, can provide significant asset protection. Most qualified retirement accounts, such as IRAs, 401ks, Roth IRAs, etc., are protected under federal bankruptcy laws and therefore are not subject to creditors in bankruptcy actions. In non-bankruptcy actions, state laws might provide protection against creditors, and most states do. As for divorce, the protection is not as great. Generally, retirement assets are subject to division upon divorce; however, depending on the state law applied to a divorce, IRA assets might provide some protection from a divorce claim.

In addition to potential creditor protection, an IRA can provide other benefits. Creation of an IRA at a young age sets the stage for long-term growth and the establishment of dedicated retirement funds. Assets in an IRA can grow tax-deferred and, if structured as a Roth IRA, can grow tax-free.

In our experience, creating an IRA for a young child is often overlooked because many parents believe there is no ability to create one. The commonly held belief is that in order to create and fund an IRA (or a Roth IRA) the person, here the child, has to have "earned income" and hence a job. Many young people will not have "jobs" until they reach their later teen years. However, how about things like cutting the lawn (if kids even do that any longer) or babysitting? The child receives payment for doing these. Is this not a job? The IRS has said yes. Note, there might be some tax consequences to establishing an IRA or Roth IRA such as having to file a tax return or pay self-employment tax (both dependent on the nature of the income). Despite such minor inconveniences, creating an IRA can still be a worthwhile technique.

Consider Divorce Protection

The two words that many parents will mutter when their son or daughter is getting married and that creates great anxiety for many of these engaged sons or daughters is prenuptial agreement. Regardless of

CASE STUDY

THE FAMILY LLC AND THE CREDITOR

Jack creates an LLC and funds it with $5,000,000 of cash. Jack then gives each of his four children a 20% interest in the LLC and retains 20% for himself. The LLC's purpose is to be a family investment vehicle to invest in marketable securities, venture capital deals, and real estate. Tony, the oldest child, through some bad business deals he is involved in, has creditors seeking significant funds. Tony has no substantial assets except his interest in the LLC. Tony's interest in the LLC is a minority interest with no right to determine liquidation, distribution, or any aspect of control of the LLC or its assets. In addition, the state law that applies here only gives the creditors a right to a charging order. Jack has no intention of making distributions from the LLC. Therefore, creditors are forced to negotiate a settlement with Tony for pennies on the dollar.

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the anxiety that it might cause, a properly negotiated and timely executed prenuptial agreement is still a technique that can provide significant protection in the event of future divorce. It is important that the prenuptial be carefully considered, that each party to it is properly represented by independent legal counsel, that "wedding night" prenuptials be avoided, and that other proper procedures are followed.

Note, while prenuptials are an important consideration, the protections afforded by such are not absolute. In addition, even properly executed prenuptials might be challenged in court and, at the very least, might create an awkward conversation for couples and their parents. Therefore, even if a prenuptial is in place, and especially if one is not, consideration should be given to incorporating other techniques as discussed above, such as trusts for making gifts and testamentary bequests.

In addition to prenuptials, other divorce protection techniques might be considered. Such techniques might include a postnuptial agreement. A postnuptial is similar to a prenuptial in that it is an agreement entered into between a married couple setting forward rights and obligations of each spouse upon a divorce. The main difference is that such an agreement is entered into after the couple is married. Because of the timing of such agreements, i.e., after the marriage, and the nature of the agreements themselves, the likelihood of challenge upon divorce can be even greater with a postnuptial than a prenuptial. Another technique that might be considered is a separate property agreement. Such agreements, popular in community property states such as California, set forth the agreement of spouses that property that was separately owned before the marriage will continue to have such treatment after the marriage.

People today are waiting longer to getting married and non-married couples are becoming more common. In these situations, protecting one's assets in the case of a dissolution of the relationship is still an important consideration. A cohabitation agreement might be considered to assist. Cohabitation agreements are rooted in the basic premises that a couple, although not married, has adopted many of the tenets of marriage. Basically, such an agreement is a contract that establishes rights and duties with regard to property and finances. In addition, they can address items such as inheritance and medical decisions. However, although possibly helpful, there are a number of possible risks that might arise out of such an agreement. For example, a cohabitation agreement might be evidence of a common law marriage.[6] Additionally, in some states such agreements are void as cohabitation is illegal. Furthermore, because the couple is not married, transfers between them, including possibly placing assets in a joint account, could result in a taxable gift. Therefore, like a pre-nuptial or post-nuptial agreement, a cohabitation agreement should not be entered into without legal guidance.

NO PERFECT APPROACH

Like many things in life, there is rarely one right way to do something. This includes creating a succession plan, where there is no perfect formula when trying to identify and address issues that are important in creating such a plan. Instead, much has to do with asking yourself the tough questions and determining what is really important to you. This first paper hopefully starts to trigger those questions and thoughts. Our next paper in this succession series will be to look at the issues and concerns from the junior generation's viewpoint.

[2] *In 2010 there was a rush to make gifts as it appeared that the exclusion from gift tax would be eliminated. Ultimately the exclusion was not eliminated.*

[3] *12 Delaware Code § 3303(a).*

[4] *Generally such holder should be independent and not related or subordinate to the grantor.*

[5] *A recent case in Massachusetts has created a question whether such assets, at least in Massachusetts, would be divorce protected. A similar question exists in other states.*

[6] *Not all states recognize common law marriage.*

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