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Estate Planning

Ideas to help you plan for your future

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Closely-Held Stock: Plan Before the Discounts are Gone

If you own a closely-held business, now may be the optimum time for estate planning. Signals from Washington indicate that some valuation discounts, which are often used to avoid estate and gift taxes with respect to transfers of closely-held stock, may be outlawed. Transfers made before the enactment of such legislation could save individuals from paying substantial amounts of tax.

One technique often used in estate plans for owners of closely-held businesses, is making gifts of interests in the business and claiming valuation discounts with respect to the stock given. By doing this, the individual making a gift is able to give away a larger amount of the stock, because the value of the stock is decreased due to valuation discounts.

An example being: I own 100% of the stock of a closely-held business. I make a gift of 20% of the stock in the business to one of my children. When I file a gift-tax return with respect to that gift, I am required to report the "fair market value" of that gift on the gift-tax return; this will often require an appraisal of the gift.

The appraiser will start by determining the value of the entire corporation. This is often done by comparing the corporation with the value of similar publicly traded stock, as well as an analysis of the cash flow of the business and the underlying assets of the business.

The appraiser then applies a discount for "lack of marketability" to the stock, which I am giving to my child. The basis for this discount is that the stock cannot be readily sold, whereas publicly traded stock could immediately be converted to cash by sale on the stock exchange. Further, the number of people who would be interested in purchasing stock in a small business is limited, and this reduced market of possible purchasers affects the value of the stock.

A discount of 15% to 20% for lack of marketability is not unusual.

The appraiser will also apply a discount for minority position or lack of control. The idea is that in a corporation, the majority shareholder controls the election of the Board of Directors, which in turn controls the operation of the corporation and the payment of dividends. A majority shareholder could employ himself and his family members as corporate officers, and pull out much of the earnings of the corporation in salary and benefits.

The 20% of the stock, which I am giving away, does not have the ability to control the corporation, and, therefore, the value of that block of stock is less than if it had control.

A discount of another 15% to 20%, or higher, is often applied in valuing closely-held stock.

The sophisticated use of valuation discounts can save huge amounts of estate tax.

For instance, suppose I give 40% of the stock in my corporation to my children, and 30% of the stock to my spouse or to a trust for my spouse. Those blocks of stock qualify for the discount for lack of marketability and the discount for lack of control, since separately neither block can control the corporation.

When I die with the remaining 30% of the stock in my estate, that stock will also qualify for similar valuation discounts. I make certain to put that stock in a trust for my spouse, so that it is not in the spouse's name when the spouse dies. Even if the trust in my estate is a so-called QTIP trust, which is taxable in my spouse's estate, the stock will be valued as a separate 30% block, and will qualify for valuation discounts.

Further, the stock I gave to my spouse during my lifetime will be reported on the spouse's estate tax return, but that block will also qualify for valuation discounts.

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If I have planned carefully, at least 35% of the value of my corporation may escape estate tax. If we assume that my business is worth $10 million, the 35% not taxed due to valuation discounts would be $3.5 million. The combined state federal estate tax on an estate of $10 million is about 53%, and using valuation discounts would save close to $2 million, or more, in taxes.

The government realizes that these valuation discounts, while having a theoretical underpinning, may sometimes be illusory. When all is said and done, after my spouse and I are gone, everything will wind up with my children, and when the children sell the business they will get 100 cents on the dollar.

Recently legislation has been proposed to change this.

In May, the administration published its Green Book, which is a book outlining some of its revenue and tax proposals. One proposal is to disregard, for gift and estate tax purposes, restrictions upon transfers of interests in closely held business organizations. When read broadly, the disregarded restrictions could include valuation discounts, especially the discount for minority position.

The Green Book clearly says that one goal is to aggregate the holdings of stock held by a surviving spouse and a trust in the deceased spouse's estate. So, in the example above, the stock held in the trust in my estate for my spouse would be aggregated with the spouse's stock, to total 60%. It would not qualify for the minority position discounts, which the two separate blocks of stock currently enjoy.

The administration has indicated that it would agree to a continuation of the $3.5 million estate tax exemption, rather than reverting to the $1 million exemption in 2011. Considering the size of the national debt, however, something more needs to be done to raise revenue.

Making changes to the valuation rules would be something below the radar, and would generate additional estate taxes, while still maintaining the $3.5 million estate tax exemption.

The potential changes in valuation rules are not the only reason for making transfers of closely held business interests at this time.

The economic turmoil we are experiencing has depressed the stock market, but this turmoil has negatively affected the value of many closely-held businesses. The ability of those businesses to obtain capital has been severely restricted. Further, a common basis for valuation using a capitalization of cash flow often starts with the current return on government bonds. As you know, the interest rates on government bonds are currently very low, which reduces the starting point for a capitalization rate.

Additionally, some of the techniques we use for effecting family transfers, such as sales to Intentionally Defective Grantor Trusts, are based upon interest rates. With interest rates being so low, these vehicles are a great way to transfer wealth to subsequent generations with a substantially lower gift and estate tax cost.

You should not let this opportunity pass. If you have any thoughts about protecting your family business from estate taxes, now is the time to take action.

A Pre-Nuptial Agreement is as Important as the Wedding Itself

Often, married couples seek our advice about estate planning after the birth of their first child. These couples are wise to be proactive about estate planning, but truly the best time for couples to develop an initial estate plan is before marriage. This is true not only for individuals who are re-marrying and possibly combining children from previous marriages, but also for individuals who have specific assets they wish to protect, such as a business or family wealth.

We suggest that couples have a frank discussion before they marry to determine whether they should execute a pre-marital agreement. While pre-marital agreements are viewed as legal documents used by the wealthy to protect assets during a divorce, they may also be used to protect assets from statutory claims of the surviving spouse upon death, as well as delineate the obligations of each party during the marriage.

A common concern for couples in a second marriage is that each spouse wants to provide for the surviving spouse, but also wants his or her children from the first marriage to inherit. Another potential concern is ensuring that a family business or specific family assets stay in that blood line following a divorce or death.

An individual who wants his children to inherit from him, instead of his new spouse's children, may ensure that outcome by executing a pre-marital

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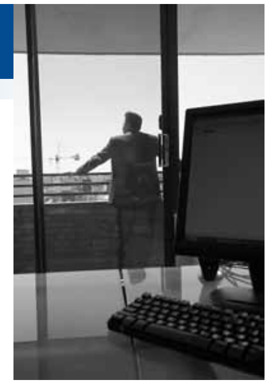

Review and Change Your Estate Plan After A Separation or Divorce - To Avoid Unintended Results

When a couple divorces dozens of pressing legal questions emerge. Who will care for the children? How will property be divided? Which spouse should receive alimony? Given the numerous decisions that accompany divorce, it comes as no surprise that most individuals do not include their estate plans as an immediate concern.

Many states have default rules that address the effect of a divorce on Wills. The standard rules, however, do not cover every possible situation. The laws contain gaping holes that can create problems if an individual fails to change probate-related documents, after commencing a separation or divorce.

New York, North Carolina, and Florida have statutes that create conclusive presumptions about a divorce. Each state's laws vary slightly, but they all conclude that once a court grants a divorce, the divorce revokes all dispositions to a former spouse in a Will. Bequests to an ex-spouse are interpreted as though the former spouse predeceased the testator. The property is distributed to a successor beneficiary or according to the state's intestacy rules. Property meant for the spouse often goes to the estate's residuary, or the decedent's children or parents. In addition, after a divorce, designation of the former spouse as an executor in a Will is generally ineffective.

Numerous problems can arise, however, when individuals are separated, but not divorced.

Couples are often separated for a period before a court formally grants a divorce. In fact, North Carolina requires couples to live apart for a year before the state grants a divorce. During the separation period, state laws regarding the revocatory effect of divorces upon Wills are not applicable. If an individual dies during the separation period, the state will treat the estranged spouse as though the couple was still happily married. The result? If the Will gives everything to the testator's spouse, that spouse inherits the assets despite the marital strife, unless the couple has a pre-marital or separation agreement that addresses inheritance. Worse yet, if the decedent did not have a Will, the surviving spouse can inherit all or some of the assets through intestacy.

Laws contain gaping holes that can create problems if an individual fails to change probate-related documents after commencing a separation or divorce.

The chances of this occurring during the pendency of a divorce are rare. But we have handled cases where this exact scenario has occurred. Needless to say, proceedings between the estranged spouse and the decedent's blood relatives were complicated and tense.

Further issues arise when an estranged spouse is named the executor in a former spouse's Will or if the former spouse dies without a Will. If the couple is merely separated, the court still views the marriage as valid. Therefore, the court may permit the estranged spouse to serve as the personal representative, unless other family members protest the appointment and prove to the court why the estranged spouse is unfit to serve. As personal representative, the estranged spouse can make numerous important decisions for the estate. Often, the wishes of the estranged spouse sharply contrast with the desires of the decedent's surviving family.

To avoid this unfortunate scenario, an individual should change his or her estate plan when contemplating a divorce or soon after separating from a spouse. In addition, once a couple actually separates they should enter into a separation agreement, which states that they both agree to waive any rights they would normally have in each other's estates as a result of death and each agrees to be treated as having predeceased the other spouse. This ensures that the surviving spouse cannot exercise his or her right of election and prevents the spouse from receiving a portion of the deceased spouse's estate if he or she is not provided for in the Will.

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agreement, along with a new Will. The agreement can form a legally binding contract that commits one spouse, or his estate, to providing for the other spouse during the rest of her life, while ensuring that assets are inherited by the children from a first marriage.

A pre-marital agreement may also be used to protect a family business or real estate that an individual wants children to inherit. Aside from insuring that the business stays within a line of descent, a premarital agreement can ensure that assets in a family business or real estate are not sold to fulfill a surviving spouse's bequest.

An estate-planning session with an attorney before a marriage also provides an opportunity for a couple to discuss their end-of-life decisions with one another. Discussions about Powers of Attorney or health-care decisions rarely come up during dating. But, if a couple meets with an attorney before entering a new marriage, the couple may learn about how each spouse wishes to deal with end of life decisions and proper documents can be executed to carry out those decisions. Further, an estate-planning session also allows the couple to discuss other topics, such as burial arrangements and funerals.

If you are considering entering a marriage, meeting with an attorney before the wedding creates an opportunity for discussion between you and your future spouse about each person's expectations. The meeting also allows you to put your instructions in writing so future disputes may be avoided.

The best time for couples to develop an initial estate plan is before marriage. This is true not only for individuals who are re-marrying and possibly combining children from previous marriages, but also for individuals who have specific assets they wish to protect, such as a business or family wealth.

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