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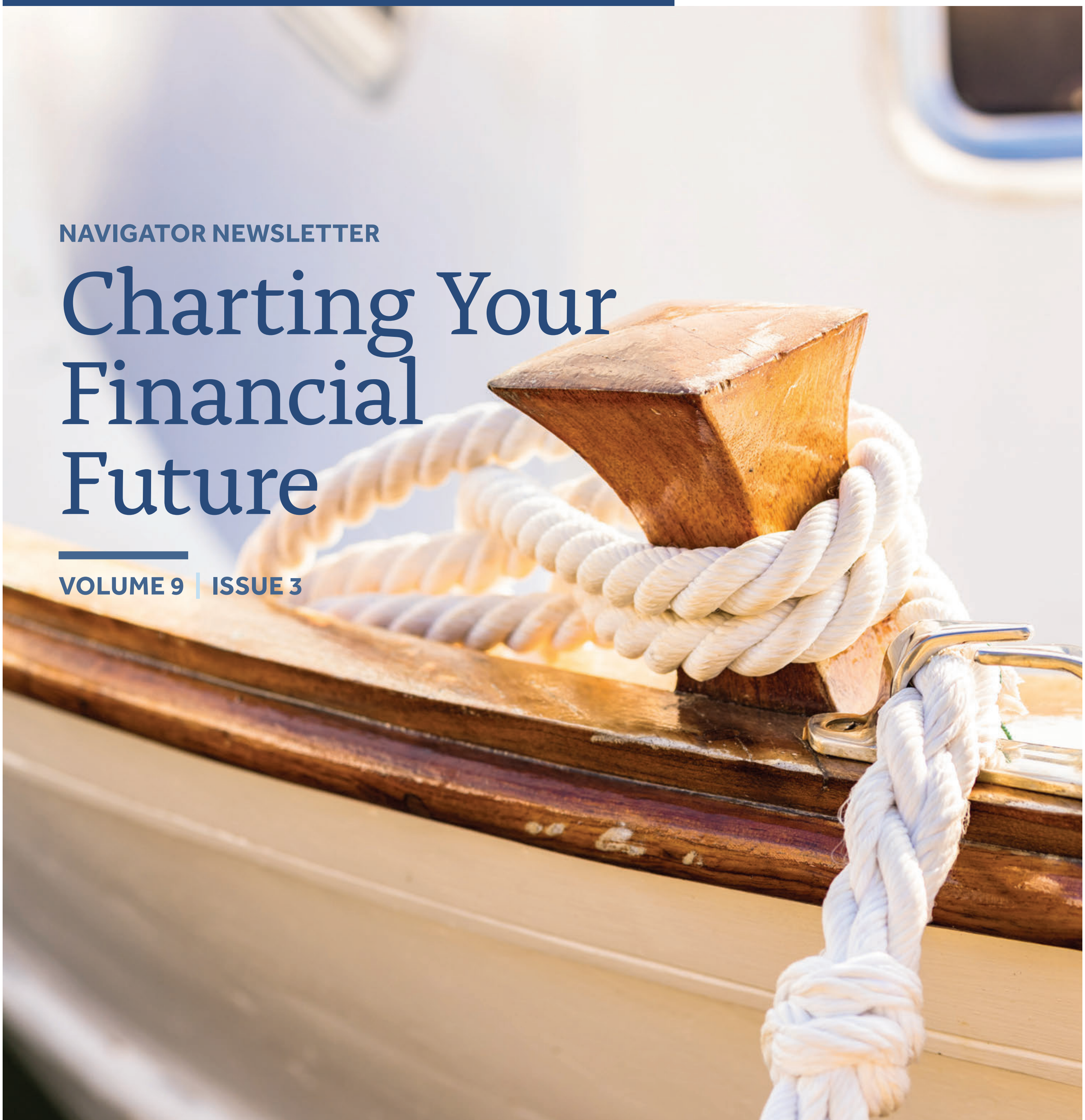


NAVIGATOR NEWSLETTER

Charting Your Financial Future

VOLUME 9 | ISSUE 3

Trustee selection considerations.

By Eva Stark, JD, LL.M.

Many estate plans incorporate a revocable trust, an irrevocable trust, or both. Revocable trusts are typically set up to facilitate asset management during lifetime as well as to avoid probate and maintain privacy after death. Irrevocable trusts are generally created to help reduce estate taxes, protect assets from creditors or for special purposes such as providing for a special-needs child.

When a trust is contemplated or drafted, the issue of trustee selection necessarily arises. Who should serve as trustee? Should a family member (or friend) serve, or should a corporate trustee be selected? What should a grantor consider when selecting a trustee?

THE TRUSTEE'S ROLE. To understand what qualities are important in a trustee, it is important to understand the role of a trustee. The trustee is the person or entity who holds legal title to all trust assets and has a fiduciary duty to hold and manage the assets for the benefit of the trust beneficiaries. The most common roles of the trustee are record keeping, handling accounting matters, filing any required tax returns, tax planning, managing investments, making distributions to beneficiaries, exercising discretion in making distributions, and keeping beneficiaries informed; all as required by the trust instrument and applicable law.

TECHNICAL KNOWLEDGE. In order to carry out the myriad of duties required of a trustee, he, she, or it must have a broad range of technical knowledge and great organizational skills. As a result, corporate trustees generally employ professionals with substantial accounting, tax, trust administration, and legal experience and have sophisticated systems and software in place. In contrast, an individual trustee will often lack the knowledge and skills to carry out all of these duties. He or she will typically need to engage professionals such as accountants, attorneys, and financial advisors or risk breaching his or her fiduciary duties.

If a trust holds an interest in a closely-held family business, it is also important to ensure that the trustee understands the business. It is unlikely that a surviving spouse or a corporate trustee will have the requisite knowledge. A "special business trustee" can be considered to make decisions and take actions with respect to business interests held by the trust. Potential candidates for a special business trustee may be a family member who is actively involved in the business or a senior manager or executive working for the business.

UNDERSTANDING THE NEEDS OF INDIVIDUAL BENEFICIARIES. A family member serving as trustee is likely to have a deeper understanding of beneficiaries' circumstances and needs as well as family values and may be more effective at fulfilling the grantor's intent with respect to trust distributions. A corporate trustee will generally lack such depth of understanding and will likely use a more "one-size-fits-all" approach.

Familiarity with the beneficiary's needs can be especially important for special needs trusts, as an example. A special needs trust is a trust typically established for disabled children with the goal of enriching their lives without disqualifying them from government benefits. An individual trustee close to the beneficiary will be better able to direct resources toward expenditures that most improve the beneficiary's quality of life; however, familiarity with the law for these trusts is paramount.

CONFLICTS OF INTEREST.
Although all trustees must act in the beneficiaries' best interests, conflicts of interest can arise for both corporate and individual trustees. An institution may offer a multitude of products and services in addition to fiduciary services (such as investment products, banking services, etc.) which creates an incentive to steer assets in the direction of its own products and services without investigating better or less costly alternatives. Similarly, an individual trustee who is also a beneficiary, for example, may favor distributions to himself or herself or his or her descendants instead of other trust beneficiaries such as a step-parent or sibling. It is important for both individual and corporate trustees to recognize such potential conflicts and manage them accordingly.

RELIABILITY. Corporate trustees will typically be banks or trust companies, many of which have been in business for generations and are likely remain in place for many more. Individual trustees, on the other hand may die, become disabled, or refuse to serve as trustee when the time comes.

COST. Individual trustees typically serve for free but may expend trust resources for professional advice. Corporate trustees on the other hand can charge high fees which may render smaller trusts uneconomical. Individuals considering a corporate trustee should comparison-shop and evaluate the fees and services offered by various institutions. Avoiding a corporate trustee solely because of the potentially high upfront costs may be "penny wise and pound foolish" in the long run. Also, if a costly error does occur, a corporate trustee has the financial ability to reimburse the trust for the mistake; an individual trustee is unlikely to have the wherewithal to do so.

INDIVIDUALS TO BE AVOIDED. It is important to note that depending on the goals of the grantor and the trust's provisions, certain persons should never serve as trustee. For example, the grantor of an irrevocable trust created for estate tax reduction purposes generally should not serve as trustee of his or her trust as it could result in the inclusion of trust assets in the grantor's estate. Similarly, a spouse who is an insured on a policy owned by an irrevocable life insurance trust should also generally not serve as trustee since the life insurance policy could arguably become includible in his or her taxable estate. There are many situations where certain individuals should be avoided. It is important for clients to discuss with their attorney any limitations with respect to whom may be appointed trustee.

THE BEST OF BOTH WORLDS?
Choosing an individual trustee or a corporate trustee is not a binary decision. In many circumstances it may make sense to appoint an individual and a corporate trustee as co-trustees. The individual trustee may make decisions regarding distributions while the corporate trustee may handle other duties such as record keeping, accounting, tax questions or discretionary distributions.

MAINTAINING FLEXIBILITY. When creating a trust, it is important to name successor trustees or have a mechanism for the appointment of successor trustees. Where a corporate trustee is contemplated, grantors might also consider incorporating language for the removal of the corporate trustee, with or without cause, in case the trustee's handling of trust assets becomes unpalatable to trust beneficiaries or if the corporate trustee is acquired by a less favorable company.

Eva Stark, JD, LL.M., joined The Nautilus Group in 2014 to assist with the development of estate and business plans. She also performs advanced tax research. Eva graduated summa cum laude with a BS in economics and finance from The University of Texas at Dallas. She earned her JD, with honors, from Southern Methodist University, where she served as a student attorney and chief counsel at the SMU Federal Taxpayers Clinic. She received her LL.M. in taxation from Georgetown University Law Center. Prior to joining Nautilus, Eva worked in private practice in tax controversy, business law, and litigation.

Business Planning

Value and private enterprise.

By Wes Shelton, CEPA, CM&AA, SM2 Advisors

Private capital markets are one of the great mysteries of our lifetimes. That may be just a tad bit of hyperbole there, but perhaps it's well deserved. Over the next ten years, this country will see the greatest wealth transfer in the *history* of the world. No hyperbole needed. As U.S. Baby Boomers retire in droves, privately owned businesses will change hands en masse, to the tune of $6 trillion by some estimates. That's more than the GDP of Japan.

Why such a mystery? Pick up the *Wall Street Journal* on any given weekday and you'll easily find the current valuation of any number of publicly traded firms, down to single shares of stock. Private firms? Not so much.

There's no established market for shares of stock in private firms, and transactions that take place are highly shrouded in confidentiality. Financing is not as easy to come by for private firms, nor are they typically as well managed or staffed. They have less recognized brands, operational controls, policies and procedures, and capital. They reinvest less and have more lax hiring practices. Generally speaking, private firms are not nearly as well operated as publicly traded firms, and valuations tend to reflect that.

This gulf between public and private valuation is, in large part, driven by business owners who lack understanding of what actually drives enterprise value. They may have every bit of competence when it comes to driving profitability within their own firms, but profit and enterprise value are not the same thing.

The first and most prevalent fallacy among business owners is that value is purely a function of profit. My company has had business owners suggest to us that their businesses are valuable because of the type of industry that they are in. For example, a few years ago, we met with a man who owned and operated a large marine-based business in South Florida, a prominent industry in the area. When we asked him what he thought it was worth, he suggested a multiple over 10x earnings, which is unusually high. Why? Because, he stated, "It would be a cool thing to own."

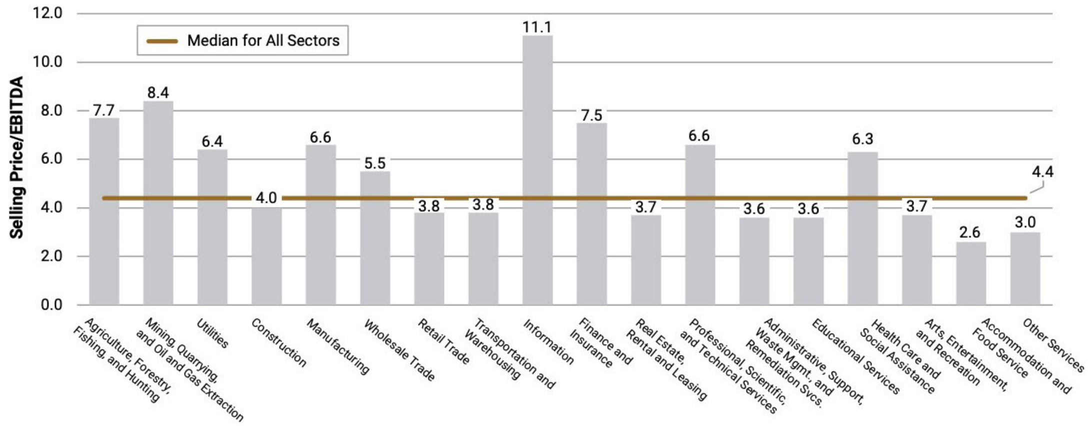
The truth is, there are many factors that drive value in a firm. A few are universal, and others more industry related. Universal value drivers are factors like recurring revenue, customer diversification, longevity of key management, positioning in growth markets, defensible market position, etc. Industry specific drivers, for a manufacturing company for instance, could be factors like resistance to overseas outsourcing or proprietary vs. contract manufacturing products.

Two Categories of Value Drivers

All enterprise value drivers can fit into one of two categories: Risk and upside/growth potential. Buyers of businesses want low risk and high growth potential. If you can build a business where you mitigate risk as much as possible, and position yourself for high growth, you more than likely have a very valuable enterprise that would trade at a high multiple. Conversely, if your business has high risk and low growth potential, regardless of profit, you're probably not going to get many offers.

Risk

These days, businesses with a recurring revenue component and low risk tend to trade at the highest multiples. That's why so many types of enterprises are going with a subscription or membership-based model, even at a nominal monthly figure. They know that if they can get you to sign up, they're unlikely to lose you, at least in the near term. Additionally, their business value just went up exponentially as a function of your yearly subscription fee. Transactional, seasonal or cyclical businesses, and businesses that sell discretionary products (like boats or jewelry) are generally less desirable because of the perceived risk.



Business owners often try to underplay risk, usually out of naivety. "We'll never lose that customer; he loves us." But buyers know where to look to find it. While risk can never be eliminated completely, it can be mitigated. Savvy business owners will seek every means possible to mitigate their firms' risk to increase value.

Upside-Growth Potential

Sophisticated buyers look for businesses with significant upside potential and will pay big bucks for them, which is why software companies are so popular and regularly fetch double digit multiples. Scalability plays a big part in this. Businesses that exhibit flat or downward growth trends are extremely difficult to sell. Buyers want to know that they can not only maintain the current level of earnings, but grow them. If not, they will gravitate to an industry or business where they can. Buyers often search for well-managed firms whose growth prospects are constrained by lack of capital. This is especially true for private equity firms that are flush with cash and tend to prefer to partner with existing management rather than bring in their own.

Unlike risk, growth potential is not as easy for a firm to control. For a firm facing limited growth prospects, it could take years to roll out a new product or service, or enter a new market with the existing offering. Nonetheless, buyers will pay a premium for businesses that have significant growth potential and business owners should know that.

A frequent question that a prospective buyer asks during the sale process is, "How would you grow this business if you were me?" The sellers' response is always very telling. If the sellers cannot make a solid and clear case for growth, then the buyers usually lose interest. If the sellers are simply limited by capital, that's a problem that can be fixed.

Opportunity

There is a knowledge vacuum when it comes to business owners and how they understand value. The Exit Planning Institute estimates that four million businesses will change hands over the next ten years as Baby Boomers retire. Yet, many of these owners don't know what their companies are worth and if they are prepared for retirement.

This represents a tremendous opportunity for advisors to add value to the exit planning process and educate the business owner on driving value in private enterprise, by putting a plan in place to grow that value before they are ready to "hang 'em up."

The online marketplace tells us that 70% to 80% of businesses that go to market never sell. That's because owners are not prepared. Some will hire trusted advisors to bridge this gap, and some will not.

As Benjamin Franklin would say, "By failing to prepare, you are preparing to fail."

Wes Shelton, CEPA, CM&AA, works at SM2 Advisors helping Nautilus member clients nationwide by providing valuable research, analytics, strategy and deal structuring to optimize outcomes. Wes earned his bachelor's degree from Southern Methodist University in Dallas, TX, and his MBA in finance from the H. Wayne Huizenga School of Business at Nova Southeastern University in Fort Lauderdale, FL. Wes also serves on the board of directors of several community organizations with a specific focus on helping foster children.

Impact of large gifts, “clawback” under estate tax law's potential sunset in 2026.

By R. Matthew Pate, JD, LL.M.

Under the Tax Cuts and Jobs Act of 2017 (TCJA), the estate and gift tax lifetime exemption amounts were doubled from approximately $5.5 million to nearly $11.2 million. In 2026, however, unless Congress acts, the exemption will revert to the lower level provided under prior law (with inflation adjustments), essentially reducing the exemption by half.

As a result, many large estate owners are currently contemplating gift arrangements that could take advantage of a potentially temporary estate tax break.

For example, assuming inflation of 2%, an individual with an estate of $12.84 million would face no federal liability on December 31, 2025, but a $2.5 million estate tax the following day, on January 1, 2026. He or she may therefore consider making a large gift to family members or trusts for their benefit prior to expiration of this law.

Because of the manner in which estate taxes are calculated, however, professional advisors may tap the brakes on such gifts due to so-called “clawback” of prior gifts.

What is clawback?

Clawback is the risk of prior gifts being brought into the taxable estate when future estate tax exemptions are lower than when the gift was made. Under the rules governing the computation of federal estate taxes, a taxable estate is increased by prior taxable gifts, then reduced by the then available (at death) estate tax exemption amount (as well as gift taxes previously paid). As a result, an individual who had taken advantage of generous gift tax exemptions faced the prospects of a higher estate tax liability than a similarly sized estate (due to a “clawback” of such gift for estate tax purposes). This was most recently a planning concern in 2012 when the $5 million gift tax exemption was scheduled to sunset at the end of the year and revert to $1 million.

For example, clawback theoretically includes prior taxable gifts initially shielded from gift tax in the taxable estate without a corresponding increase in the available estate tax credit.

	$5M Exemption	Sunset to $1M Exemption
Estate Assets	$1M	$1M
Prior Gifts	$5M	$5M
Tentative Tax Base	$6M	$6M
Tentative Tax	$2.08M	$2.08M
Unified Credit	$1.73M	$346K
Net Tax	**$350K**	**$1.73M**

What did Congress and the US Treasury Department do under the TCJA?

Clawback was avoided in 2013 when the law was extended and then subsequently modified with the TCJA, but the prospects of a divided Congress for the foreseeable future coupled with generous estate exemptions nonetheless seem to heighten the risk that sunset will occur in 2026.

Understanding this potential, legislators provided some guidance within the text of the legislation itself.

Specifically, Section 2001(g) included a conforming amendment that required Treasury to issue regulations necessary to account for any difference between the exclusion amount applicable at the time of a decedent’s death, and the exclusion amount applicable with respect to any gifts made by the decedent.

Treasury’s subsequent guidance (issued as proposed and temporary regulations in November 2018) addressed some of the primary concerns, but left several other questions unanswered (note as well that legislation and regulations can always be modified in the future).

NO ESTATE CLAWBACK FOR GIFTS THAT EXCEED NEW EXEMPTION

The regulations provide that a decedent’s available estate tax credit amount is to be increased by any higher amount previously available when a taxable gift was made. For example:

	$5M Exemption	Sunset to $1M Exemption
Estate Assets	$1M	$1M
Prior Gifts	$5M	$5M
Tentative Tax Base	$6M	$6M
Tentative Tax	$2.08M	$2.08M
Unified Credit	$1.73M	$346K
Additional Credit to $5M Gift	0	$1.384M
Net Tax	**$350K**	**$350K**

BUT TAXABLE GIFTS APPEAR TO COME FROM BOTTOM OF EXEMPTION PILE

While the regulations do not explicitly address what portion of the exemption is assumed to be used in the event of gifts, it appears that gifts will be assumed to come from "the bottom" of the exemption pile. As a result, it would appear that the increased exemption available under current law is only truly beneficial to the extent gifts exceed the exemption available post-sunset.

For example, assume a $5 million gift is made during a $10 million exemption period, leaving an individual with a $5 million estate exemption currently. If a reversion to a $5 million exemption occurs, such individual will be considered to have used $5 million of the then exemption, per the following:

	$11.18M Exemption (2018)	Sunset in 2026
Estate Assets	$6.18M	$6.18M
Prior Gifts	$5M	$5M
Tentative Tax Base	$11.18M	$11.18M
Tentative Tax	$4.4M	$4.4M
Unified Credit	$4.4M	$2.5M
Effective Additional Credit	0	0
Net Tax	**0**	**$1.9M**

WHICH MEANS INFLATION ADJUSTMENTS POST SUNSET MAY BE LOST AS WELL

One additional impact of the methodology to account for large gifts post sunset is that such gifts may result in the loss of inflation adjustments as well. For example, assume a gift is made that exceeded the post sunset exemption amount. It appears that the benefit of future inflation adjustments will not be available to such individual until the new exemption exceeds the value of the prior gift.

Pre-Sunset Gift	$10M
Exemption Post Sunset	$6.5M

No additional estate and gift exemption would become available in this situation until the exemption reaches $10 million under inflation adjustments.

WHAT ABOUT PORTABILITY OF HIGHER EXEMPTION POST SUNSET?

Lastly, a related question concerns whether an exemption available under spousal portability is impacted by sunset. For example, assume a husband dies in 2025, allowing his spouse to port over a $12 million exemption. If his spouse survives into 2026, her own exemption would be reduced under sunset.

What about the portable exemption? While the proposed clawback regulations do not address this question, regulations applicable to portability seem to provide that the higher $12 million amount remains available to the surviving spouse (i.e., whatever exemption was passed under portability remains).

In summary

The anti-clawback regulations provide welcome guidance for those contemplating large gifts prior to sunset, as well as those who may have made large gifts and paid gift tax prior to the increase in the exemption in 2017; but it is important to note that the current increased exemptions do not appear to permit preservation of the marginal difference through gifting.

Note as well that the current regulations are only proposed, and it is possible that additional changes are made to the final regulations that modify these conclusions.

R. Matthew Pate, JD, LL.M., joined The Nautilus Group in 2004 after receiving his masters in law in taxation from Southern Methodist University's Dedman School of Law. Matt is a manager within the Nautilus case development unit, where he applies his extensive experience in estate and business succession planning, tax issues involving closely held businesses, asset protection, and charitable planning arrangements. Matt employs a customized and high touch approach to suit the unique circumstances of the case specifics and the client's objectives. He received his BA from Georgetown University and graduated from the University of Texas School of Law in 2001.