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The 2017 Estate Planning Teleconference Series

Participant Guide

Family Business Succession Planning: Now More Challenging Than Ever

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Presents

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By:

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TABLE OF CONTENTS

Page

A. IRS Releases Notice That May Lead to Revision of the Proposed Regulations under IRC § 2704(b) Notice 2017-38, 2017-30 I.R.B. 147 (July 24, 2017) 1

B. Navigating the Minefield of Having Children Who Are Active in the Business and Those Who Are Not 1

1. The Typical Conflicts 2
2. Some Planning Alternatives 2
   a. Equal Distribution of Identical Business Interests 2
   b. Allocating Control to Insiders 3
   c. Distribution of Business Interests Only to Insiders and Distributing Other Assets to Outsiders 3
   d. Granting Outsiders Limited Decision-Making Powers 4
   e. Puts and Calls 4
   f. Outsiders Who May Later Become Active in the Family Business 4

C. Estate Planning Structures That May Be Compatible With Family Business Equity 5

1. Effective Use of Trusts 5
2. Allocation of Business Interests Among Trusts 5
3. Dispositive Provisions of Continuing Trusts 6
4. Selection of Trustees 7

D. Anticipating and Addressing Family Members' Marriages and Divorces 8

1. Premarital and Postmarital Agreements 8
2. Irrevocable Trust Planning 9

Family Business Succession Planning: Now More Challenging Than Ever

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A. IRS Releases Notice That May Lead to Revision of the Proposed Regulations under IRC § 2704(b)

Notice 2017-38, 2017-30 I.R.B. 147 (July 24, 2017)

On April 21, 2017, President Trump signed Executive Order 13789, directing the Treasury Department to conduct a comprehensive review of all "significant tax regulations" issued on or after January 1, 2016 and issue a report identifying all regulations that: (1) impose an undue financial burden on taxpayers, (2) add undue complexity to federal tax laws or (3) exceed the authority of the Internal Revenue Service ("IRS"). The IRS, in this Notice, identified eight such regulations, including the proposed regulations under Internal Revenue Code ("IRC") § 2704(b). REG-163113-02 (August 4, 2016). The proposed regulations concern the ability to liquidate family-controlled entities and would create an additional category of restrictions that would be disregarded in assessing the fair market value of an interest in such an entity. Commenters on the proposed regulations argued that they would eliminate or restrict commonly understood and accepted types of valuation discounts, such as minority discounts and discounts for lack of marketability, resulting in higher valuations and transfer tax liability that could be unduly and unjustifiably burdensome on taxpayers. Commenters also asserted that the proposed regulations would make valuation of closely-held business interests more difficult and that they were arbitrary and capricious.

The Executive Order directed the Treasury Department to submit to the President a report "that recommends specific actions to mitigate the burden imposed" by such regulations. Such actions may include delaying or suspending the effective date of regulations or modifying or rescinding such regulations. The deadline for such report was September 18, 2017.

B. Navigating the Minefield of Having Children Who Are Active in the Business and Those Who Are Not

Many closely-held business owners intend to transfer business interests to particular children who will run and/or actively participate in the operation of the business after the current owner's death or retirement. Often, before they receive any business equity, those children will have already occupied positions of responsibility in the business and were consciously being groomed for their eventual ownership roles. Where the business is the largest single asset of the business owner's estate and the owner has limited other resources with which to fund his or her children's inheritances, the owner may need to pass some ownership interests in the business to his or her other children as well. *See* Berry, Jones and Redd, "Nothing Succeeds Like Successful Succession," 51ST ANNUAL HECKERLING INSTITUTE ON ESTATE PLANNING (2017).

1. The Typical Conflicts

Some of the most typical conflicts of interest surrounding a family-owned business are the conflicts that arise between family members who are active in the business' operation (the "insiders") and family members who do not work in the business (the "outsiders"). The outsiders may question the compensation and benefits received by the insiders, as well as their business decisions. The insiders may resent that their efforts are increasing the equity value of the business interest of the outsiders who, in turn, are demanding more return on their investment to which the insiders feel they are not justifiably entitled. *See* Berry, Jones and Redd, *supra*.

In addition, conflicts frequently also develop among the insiders themselves; for example, they may disagree about business strategies or day-to-day management decisions. To complicate the situation further, a business owner's spouse, who may or may not be a parent of the affected children, may become involved in the decision-making, and maintaining family harmony may be more complicated. *See* Berry, Jones and Redd, *supra*.

Thus, several issues confront the business owner as he or she attempts simultaneously to direct the financial destiny of the business and treat family members fairly. There are no easy answers to these issues, but they must be faced and a decision about the devolution of the business interests reached by the owner, ideally with the concurrence of affected family members. The practitioner should remember also that, in the context of developing succession plans for family owned businesses, "equal" is not necessarily "fair."

2. Some Planning Alternatives

a. <u>Equal Distribution of Identical Business Interests</u>. While the default plan often is to distribute the family business interests equally among all the children, this plan may not be advisable unless all the children get along well and are all insiders. For example, if the children own the stock of a family corporation equally, all have equal voting rights and there are more outsiders than insiders, the outsiders could set the dividend policy, which might not be conducive to growth and expansion of the business. The outsiders also could restrict the insiders' compensation and benefits so that the outsiders can receive a larger dividend (or, eventually, liquidation distributions). On the other hand, if there are more insiders than outsiders, the insiders could maximize their own salaries and benefits, and minimize dividends, to the detriment of the outsiders. Furthermore, if a child has been working in the business alongside the business owner for a considerable period, has foregone other career opportunities offering higher compensation to do so and has materially contributed to the success of the business, the business owner may want to give (and feel justified in giving) that child a disproportionately large share of the business interests. Perhaps, also, as a business management strategy, the business owner will want to consolidate ownership and/or control of the business in the hands of the insiders.

The decision of the Supreme Court of Pennsylvania in *Ferber v. American Lamp Corp.*, 469 A.2d 1046 (Pa. 1983), provides an example of the risks of employing an equal distribution of the business interest in the business owner's estate planning documents. American Lamp

Corporation (the "Corporation") was a closely-held family corporation owned by Benjamin Cohen. Annette Ferber, one of Mr. Cohen's daughters, was a minority shareholder and inactive in the business. Ms. Ferber's brothers (the "Brothers") acted as the corporation's officers and directors. Mr. Cohen's Will expressed Mr. Cohen's desire to have the Brothers be active in the business. The Will also stated that the profits, after distributing a portion to Mr. Cohen's surviving spouse, should be divided equally among Ms. Ferber and the Brothers.

The court explained that, from 1963-1979, each of the Brothers received $904,000 in total compensation from the Corporation (which included the use of corporate vehicles and boats for personal purposes), while Ms. Ferber received $13,553 as her share of the profits.

Ms. Ferber filed a claim demanding an accounting of the Corporation and payment of dividends. The claim also alleged that Ms. Ferber was entitled to a greater portion of Mr. Cohen's estate and that the Brothers had denied her that portion since Mr. Cohen's death. The trial court found for Ms. Ferber and determined her share of the profits that were not distributed to her to be $370,000 plus interest. The Supreme Court of Pennsylvania reversed but only with regard to proper calculation of damages.

b. Allocating Control to Insiders. It is often appropriate to separate non-managerial interests in a family business (such as limited partnership interests or non-voting stock) from the management interests (such as general partnership interests and voting stock). The non-managerial interests may then be transferred to the outsiders. There may be disadvantages to this approach. For example, similar to the situation discussed above in which all children hold equal interests and there are more insiders than outsiders, the insiders with controlling interests may have an orientation towards retaining business earnings to fund future expansion, or perhaps increasing their compensation and benefits, rather than paying current dividends, which could work to the detriment of the outsiders. This problem might be addressed by adopting a dividend or distribution policy for the outsiders' interests or otherwise classifying the outsiders' interests as preferred. The business may also implement policies prohibiting excessive compensation. Mezzullo, *supra*.

c. Distribution of Business Interests Only to Insiders and Distributing Other Assets to Outsiders. Alternatively, a business owner's estate plan can provide for insiders to receive business assets and for outsiders to receive non-business assets. This plan can be relatively easy to implement if the business owner has non-business assets sufficient to provide the outsiders with dispositions that the business owner deems fair. If this is not the case, it may be advisable for the business owner to buy life insurance that can be used to provide outsiders with non-business assets. Another variation of this technique is to provide that the business owner's estate will sell part or all of the business to the insiders, usually on favorable, preferred payment terms (*e.g.*, a long-term promissory note with low interest). Of course, the sale must be at fair market value to avoid creating unintended adverse tax consequences. *See* Berry, Jones and Redd, *supra*. The promissory note, rather than interests in the family business, can then be distributed to the outsiders. As long as a mutually agreeable purchase and sale price can be determined (or is set out in a buy-sell agreement), and as long as the insiders stay current

in their note payments, this approach can be successful. Again, however, there would be continuing involvement by the outsiders, which may be good as a transition or may create further opportunities for conflict if there is doubt concerning whether the business can make all of the required payments.

d. **Granting Outsiders Limited Decision-Making Powers**. Another approach is for the family members to adopt an agreement that gives the insiders some unilateral decision-making rights but requires one or more of the outsiders to join them for certain major decisions, such as dividend payments, acquisitions and significant capital expenditures. A problem with this approach is that the insiders could team with certain of the outsiders to the detriment of the others. Conversely, the outsiders could vote as a block on the major decisions and impede business growth.

One solution for this potential problem would be to have a designated number of non-family directors who would have the controlling vote if the insiders and outsiders could not agree on business issues. Non-family directors can be particularly helpful to the family, not only for the useful advice they might offer, but also for their ability to provide unbiased feedback on the quality of performance and the results accomplished. Non-family directors may also help ensure that the interests of those with nonvoting interests in the business are protected. A corporate Trustee may be able to fill this role, but corporate Trustees are sometimes reluctant to risk putting themselves in the middle of family business disputes. Lurie, "Coordinating Estate Planning and Business Succession," 41ST ANNUAL HECKERLING INSTITUTE ON ESTATE PLANNING (2007).

e. **Puts and Calls**. Another option is to leave the business interests equally to all the children, with the interests owned by the outsiders subject to a "put," which is a mandatory redemption at a formula price or at an appraised purchase price paid over a period of time with a reasonable rate of interest so that the business would not have to expend a large amount of cash at one time. If the outsiders believe that the value represented by their interests in the business would be more productive if liquidated and placed into other investments, they can exercise their put rights and convert their investments.

The put allows the outsiders to remain as owners or have their interests redeemed at their election. Thus, if an outsider is involved in a conflict involving the business, the outsider can simply exit the conflict by exercising the put right.

To limit the risk that the business would have to redeem an interest at an outsider's election, the put rights could be structured so that they expire shortly after the business owner dies, thereby forcing the outsiders to make fairly prompt decisions about whether to remain as owners. Further to offset the advantage a put would provide for the outsiders, the insiders could have a "call" on the outsiders' interests, exercisable after the outsiders' put rights expire. A call would allow the insiders to elect to redeem the outsiders' interests.

f. **Outsiders Who May Later Become Active in the Family Business**. What if one or more members of the next generation have not decided whether to enter the

family business by the time the business owner wants to complete his or her transfer of control and ownership? One solution may be that the owner, the business and the undecided relative can enter into an agreement through which the relative can elect to become an employee or owner of the business on terms to be established subsequently by all the family members or by non-family directors with or without the family's participation. Similarly, the same group could allow the relative to acquire a business interest at a formula or appraisal price payable using an installment method over a reasonable period of time, which would allow the relative to use his or her earnings to pay for his or her business interest. Thus, the business owner would not have to rely on the insiders alone to make the decision and establish the terms under which an undecided relative could become an employee or owner of the family business.

C. Estate Planning Structures That May Be Compatible With Family Business Equity

1. Effective Use of Trusts

An owner of family business interests may use trusts as devices to efficiently hold such interests and to transmit such interests, or beneficial interests therein, among appropriate family members in a precise, customized and advantageous manner. The business owner may initially hold the business interests in his or her revocable trust. Provisions may be included in the trust instrument directing, generally or in great detail, the manner in which and by whom, as successor Trustee, such interests shall be administered in the event the business owner becomes incapacitated. Holding business interests in a revocable trust may be preferable to the business owner's holding such interests in his or her sole, individual name and relying on the attorney-in-fact under a durable power of attorney to administer the business interest or add it to the business owner's revocable trust if and when the business owner becomes incapacitated. Third parties, though generally comfortable dealing with successor Trustees under revocable trust instruments, frequently are reluctant to deal with attorneys-in-fact under durable powers of attorney.

At the business owner's death, the trust instrument may direct: (a) to or in trust for whom the business interest shall pass; (b) who, as Trustee or otherwise, shall have voting power with respect to voting interests in the business held in the trust; and (c) the manner in which the business interests shall be administered for the benefit of the beneficiaries and ultimately distributed or disposed of. In some cases, retaining the business interest in trust, at least initially, after the business owner's death, rather than distributing it directly to the next generation, should help guard against abuse of power by those who are not yet ready to wield it.

2. Allocation of Business Interests Among Trusts

Following the death of the business owner, the Trustee of his or her formerly revocable trust will allocate the business interests held in the trust between or among the continuing trusts to be created under the trust instrument. The business owner may wish to include in the trust instrument specific directions regarding such allocation. The choices of trusts to which such business interests could be allocated may include a marital trust, a non-marital trust, separate trusts for the sole or primary benefit of the business owner's descendants with respect to whom such trusts are established and, perhaps, analogous versions of such trusts that are designed to be

exempt from generation-skipping transfer tax. To the extent not contrary to specific governing instrument provisions, the Trustee, in allocating business interests between or among continuing trusts, should consider:

- Who are the beneficiaries of the continuing trusts (and, in particular, whether any beneficiaries are active participants in the business);
- Who are the Trustees of the continuing trusts (and, in particular, whether any such Trustees are active participants in the business);
- What are the purposes and dispositive provisions of the continuing trusts;
- What are the prospects for growth in value of, or production of cash dividends or distributions by, the interests; and
- What is the known or anticipated tax posture of each of the continuing trusts?

Further, in designing provisions allocating the interests in the family business among continuing trusts, the business owner and the estate planner should consider the above-listed factors and, in addition, whether a direction that such interests should be allocated to particular trusts should supersede, or be superseded by, a general direction to allocate all property among the business owner's then living descendants, *per stirpes*.

3. Dispositive Provisions of Continuing Trusts

The dispositive provisions of the continuing trusts to be created under the trust instrument after the death of the business owner to which business interests will or may be allocated should be structured, to the extent possible, in a manner that will be conducive to the trust's holding such interests. Except in connection with a trust intended to qualify for the estate tax marital deduction, a mandatory income or unitrust amount distribution provision may not be suitable. Discretionary principal distribution provisions and/or powers of withdrawal, if included, should, depending on the business owner's desires, prohibit discretionary distributions and/or withdrawals of business interests. Alternatively, it may be appropriate not to prohibit discretionary distributions or withdrawals of business interests. In fact, it may be wise to include broad and flexible discretionary principal distribution provisions that would, in fact, enable discretionary distributions of business interests in circumstances determined by a capable Trustee.

Similar considerations should be evaluated in designing powers of appointment. If a power of appointment is to be conferred on a beneficiary, depending on the circumstances, it may be desirable to allow the donee to appoint, or expressly to prohibit the donee from appointing, any family business interests. If a given power of appointment is to allow closely-held business interests to be appointed, of course, the class of permissible appointees of such interests can be as broad or as narrow as the business owner wishes.

The business owners may also implement transfer restrictions on the business interests that dictate whether and under what circumstances current and future business owners may transfer interests in trust for a surviving spouse or other beneficiaries, including provisions

describing the extent of a trust beneficiary's right to distributions of the business interests and who can serve as Trustee. Mezzullo, "Cain v. Abel: Dealing With Sibling and Cousin Rivalries," 49TH ANNUAL HECKERLING INSTITUTE ON ESTATE PLANNING (2015).

4. Selection of Trustees

The selection of the initial Trustees and the successor Trustees is very important. In the absence of a special, overriding provision in the trust instrument conferring business interests voting power on a person who is not a Trustee or is a trust protector, the Trustees will be in control of the business interests held in trust and, if such interest constitutes a majority interest, will be in control of the business itself. Further, depending on the trust's dispositive provisions, the Trustee may have the responsibility for deciding to what extent, if at all, any family business interests are distributed to beneficiaries. Thus, the future of the family business could rest largely or completely in the hands of the Trustee.

In structuring the succession of Trustees for each trust in the business owner's estate plan, the following factors should be considered: (a) the age and maturity of the proposed Trustee; (b) the extent of the proposed Trustee's abilities generally in handling financial matters; (c) the current and/or expected future involvement, if any, of the proposed Trustee as an active participant in the operations of the business; and (d) the identity of the beneficiary or beneficiaries of the particular trust. Of course, the selected Trustee must possess the expertise and the temperament effectively to address the demands of the insiders and outsiders who have competing interests. *See* Gabbard, "Fiduciary Factors for Drafting Trusts With Closely Held Stock," ESTATE PLANNING, March 2015.

The potential conflicts of interest that may arise during the administration of a closely-held business interest is another factor that should be considered in selecting a Trustee. A Trustee, of course, must administer the trust in the best interests of the beneficiaries. If the Trustee holds a controlling interest in a closely-held business, the Trustee also must act in the best interests of the business and its other owners – who may or may not be the same as the trust beneficiaries. The will or trust instrument should include appropriate provisions exonerating the Trustee from conflict of interest claims. Manterfield & Devault, "Family Feud – Hollywood May Call it Entertainment But It Is No Laughing Matter for Family Businesses – Part II: The Advisor's Role in Business Succession Planning," 41 ESTATES, GIFTS AND TRUSTS JOURNAL 233 (2016).

Designating a young adult child of the business owner who is or is expected to be actively involved in the business as a Co-Trustee along with a corporate fiduciary can enable the child to ease his or her way into a primary decision-making role. In circumstances in which, say, only one child is an active participant in the business and a trust of which a non-actively involved child is the primary beneficiary would be funded with a portion of the business interest as well as other non-business assets, the trust instrument could designate the child who is the primary beneficiary of such trust as Trustee of such trust but designate the active participant child as the trust protector with sole authority to vote the family business interests. *See* Gabbard, *supra*.

A trust instrument should ordinarily contain provisions allowing Trustee removal and replacement. In addition to building into the removal and replacement provisions the customary safeguards, the business owner and the estate planner should also include language ensuring that, unless there is a material breach of fiduciary duty, the removal and replacement provisions cannot be used to wrest the power to control the business interests away from the person whom the business owner selected to have such control. Particular persons may be given the removal and replacement powers, and such powers may be made exercisable only under stated circumstances.

D. Anticipating and Addressing Family Members' Marriages and Divorces

Family businesses sometimes fail or falter because owners fail to anticipate the consequences of their children encountering marital problems. Fortunately, there are two primary planning vehicles that address these concerns: premarital and postmarital agreements, and irrevocable trusts.

1. Premarital and Postmarital Agreements

Premarital and postmarital agreements (collectively, "marital agreements") may allow a business owner to specify the effect that the owner's death or divorce will have on the owner's business interests. Perhaps most importantly, marital agreements may set the price at which the business is to be valued and define what constitutes marital and nonmarital property. For example, the agreement could state that, in the event of divorce, the owner's spouse is not to receive any interest in the owner's nonmarital property, even if the owner's spouse actively works in the business. Manterfield & Devault, *supra.* "Nonmarital property" should be defined in the agreement specifically to include the business interests and any income therefrom other than wages. Instead, the spouse's share to be divided may be composed of part of the marital property after considering the value of the business. This value may be determined by the purchase price set out in a buy-sell agreement or may be the fair market value of the business as a going concern as determined by an independent appraiser. Setting clear expectations regarding how the business equity is to be distributed and valued can minimize or prevent time-consuming and expensive disagreements during dissolution of marriage proceedings.

Marital agreements are particularly helpful within the context of blended families or when the business is a joint venture between spouses. Blended family concerns typically arise when an owner's children from a previous relationship are involved in the family business but the owner is unsure whether children will be born into or adopted during a new marriage. The owner may want his or her existing children's interests protected but may also want to preserve the right to provide property and/or beneficial interests to future children through his or her own estate plan should they become involved in the business.

Where the business is a joint venture of the spouses, a marital agreement can set forth how the business will be operated if the spouses agree to continue the business together after marriage dissolution or whether one spouse will then convey all business interests to the other spouse in exchange for other property and/or cash consideration.

Despite their usefulness in addressing business succession planning, marital agreements may be off-putting for younger business owners entering their first marriages. Therefore, estate planners should carefully guide younger clients regarding the benefits of addressing family business succession planning "upfront."

2. Irrevocable Trust Planning

As discussed above, there are many sound reasons for disposing of family business interests through trusts rather than by outright dispositions. In addition, if a business interest is held in trust for a child, rather than transmitted outright to the child, and if the trust instrument contains the necessary provisions, under the law of most states, that interest should not be subject to spousal claims in the event of dissolution of the child's marriage (because, for so long as it is held in trust, such interest would not be marital property or community property). The child would have the additional benefit of protection of those interests from his or her general creditors. To secure these asset protection benefits, the trust's governing instrument should contain a standard spendthrift clause, and all distributions of income and principal to or for the benefit of the child should be subject to the sole and absolute discretion of an independent Trustee or Co-Trustee. To maximize the protective nature of the trust, it could be structured so that the child is not the only beneficiary of the trust set aside with respect to him or her (his or her descendants could be concurrent beneficiaries with him or her). If the business owner wished to provide some dispositive flexibility to the child upon his or her death, the trust instrument could confer on the child a testamentary limited power of appointment.

To protect a business interest from the claims of the owner's creditors, including a spouse from whom the owner may later be divorced, he or she might consider placing the interest in a self-settled asset protection trust. Each state whose laws allow for self-settled asset protection trusts has various requirements that must be met. As one of many examples, under South Dakota's asset protection statutes, some requirements are that the trust instrument must contain a spendthrift clause and South Dakota law must govern the construction and administration of the trust. S.D. Codified Laws §§ 55-16-1 and 55-16-2. Furthermore, for assets to be protected from being subject to spousal support or property division upon divorce, the trust must be funded with the owner's separate (*i.e.* non-marital) property, or, to the extent funded with marital property, the spouse or former spouse must have been provided with notice of or consented in writing to the transfer of such property. S.D. Codified Laws § 55-16-15. Other asset protection statutes provide varying levels of spousal protection. *See, e.g.*, Okla. Stat. tit. 31 §§ 12-18 (providing that a spouse has no right to access trust for spousal support or property division upon divorce); Mo. Rev. Stat. §§ 456.5-503.2, 456.5-505 (providing that spouse has right to access trust income for support but not to access any trust assets in connection with property division upon divorce).

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