# For Trusted Advisors

Business Planning

# When is a business valuation important?

By Arthur Reed Snyder, Jr., JD

A business valuation can act as the capstone when an owner needs to build a greater understanding of his or her business. Business owners often don't know where their business stands on a given day and are only peripherally aware of the facts and figures that form the foundation of their business's financial health. Many business owners have come to discover that a business valuation is a singularly invaluable tool that can help guide them through the many phases of their business's life cycle by helping them to see where they've been, know where they are, and make plans for where they want to be.

## Benefits of a business valuation

The process of obtaining a valuation gives the owner an opportunity to look at the whole picture from a better vantage point. A business valuation can help an owner understand where their business stands today, give insight into the historical trends that their business has established for itself and give them an understanding of how healthy and sound their business is in the present. It can help an owner compare their business to others like it and provide an understanding of the business's value so an owner can know what it's worth.

A valuation provides a great starting point when it is time for an owner to sell the entire business as a going concern or even a partial interest in the business. Owners often find that the hardest part of the negotiation process is finding the starting point. They don't want to leave anything on the negotiating table, and that desire can create undue stress. The valuation lets an owner confidently establish a starting point as negotiations begin. It's important to note that the valuation isn't the be-all and end-all when value is considered, it is just a starting point. But being confident in the soundness of your starting point can mean all

the difference when a buyer and an owner come to terms. The owner must still fight for important deal terms and concede those that can be sacrificed. If an owner has faith in the starting point, he or she can conclude negotiations with some assurance that little was left on the negotiation table.

To that end, a business valuation is also a great emergency brake. It can let owners know that they are not ready to sell, yet. Owners can find themselves at the negotiating table having no support for their asking price while a buyer drives a hard bargain. Owners often find it difficult to separate the intrinsic value they place on their business from the economic value reflected in a valuation that uses widely accepted valuation principals. Whether the business's calculated value is high or low when compared to the owner's perception, the knowledge of the valuation's conclusion can be the reality check an owner needs during negotiations and can give an owner insight into whether negotiations are likely to bear fruit or whether it is time to walk away from the negotiating table. It is better to gain those insights before time and money have been spent on counsel and due diligence only to discover that hard negotiations are not going to result in a sale.

A business valuation is also very useful when it comes to matters of succession planning. When succession planning begins, owners can find themselves talking about buy-sell agreements, incentivizing employees, and identifying the business's key personnel. It is during these planning discussions that the business valuation helps an owner see and understand the hard and fast facts and figures that must be considered when trying to optimize tax, estate, and business succession consequences. With the multitude of available succession planning techniques, the business valuation becomes an invaluable tool used to support an owner's decisions and guide the planning process. It is also an important tool to use when key persons want to become owners or when it is time for family to step up to become part of the ownership group. Planning is always easier when owners and their advisors have more facts and more data. The planning process goes smoothly and quickly when all the necessary information is readily available.

## Approaches to valuing a business

Given the many ways a business valuation can help a business owner, it is helpful to understand the different ways value can be determined. The three principal ways of valuing a business are the asset approach, income approach, and market approach. Several different methods are categorized under each of these three approaches and each category's methods have many common elements among them. The business valuation can be prepared using any one or a number of these three approaches, and the valuation may also be determined by assigning a relative weight to each approach in order to arrive at a blended determination of value.

**ASSET APPROACH.** The asset approach generally determines a business's value by taking its assets and subtracting from them the business's debts and liabilities. This approach is often insufficient when valuing a service business or a business that is not capital intensive. The asset approach is subject to additional considerations like determining how the word "asset" is defined. For example, are assets valued at the historical book value of the asset or the asset's fair market value? The asset approach is limited in as much as the business's value is seen as a determination of the value of the business's parts rather than the whole.

**INCOME APPROACH.** The income approach generally determines a business's value by looking at historical earnings and projected future earnings to establish value. The most common expression of this approach is the discounted cash flow

(DCF) method. The DCF method analyzes past earnings and current earnings to determine a base set of expectations for future earnings which are projected forward for several years and then discounted back to determine the present value of the business. The approach is useful when valuing a service business or a business composed of intangible and hard-to-value assets. The income approach is subject to additional considerations like how best to account for the difference in value between a business that pays corporate taxes and one that doesn't. The income approach considers the business as a going concern and does not consider its constituent parts. In other words, income approach does not account for the separate value of the business's fixed assets or its intangible assets in the process of valuing the income stream.

**MARKET APPROACH.** The market approach generally determines a business's value by comparing the business to public companies that are similar and in the same industry or by looking at recent transactions involving similar businesses in the same industry. The approach is useful when data about similar companies is abundant and time is not. The market approach can be limited when there are not enough public companies that are comparable. It also is difficult to find comprehensive data sources that share data about recent transactions from similar companies since virtually all private transactions are not centrally tracked. Last, it is difficult to make broad assumptions about small business when the comparable companies are several orders of magnitude larger. The larger the business being valued, the greater the likelihood that relevant comparable data sets can be found to use the market approach; without that data, the approach won't generate relevant business values.

## When to begin

Beginning the process of obtaining even a thumbnail sketch of a business's value can be a very rewarding process. A business valuation can help owners gain a better understanding of their business, plan for the ultimate sale or disposition of their life's work, or help them and their successors plan for the day they cede control of the business and hand the reins over to the next generation. When all is said and done, a business valuation is an excellent tool that is easily obtained which can help business owners regardless of where along their business's life cycle they find themselves. As with all business planning strategies, working with a professional will help ensure the best results.

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Estate Planning

# Decanting: Quelling qualms about irrevocability.

By Kristen E. Simmons, Esq.

Advisors often hear the same excuses from clients for not completing an estate plan or implementing life insurance. Sometimes, the client may have already implemented an irrevocable trust and felt that it no longer met their family's needs. This may be a deterrent from using that irrevocable trust or a new trust to acquire life insurance that would provide a significant impact for the client's family. If the client is young, he or she may have concern about changing family circumstances or the fear of missing out on the next great planning opportunity, and the irrevocable nature of various planning techniques may be the roadblock. Decanting is a useful tool to quiet these common client concerns.

## What is Decanting?

The term "decant" is defined by Merriam Webster as "to pour out, transfer or unload as if by pouring." In the world of estate planning, decanting is a tool used to modify an irrevocable trust to remove unfavorable provisions, or to make adjustments based on changed circumstances. When an irrevocable trust is decanted, the trustee generally exercises its distribution power over the trust to distribute property from an existing trust to a different trust (whether already existing or newly established) with one or more of the same beneficiaries. Currently twenty-nine states have enacted statutes that permit the decanting of an irrevocable trust. Furthermore, many of the states that have not yet adopted their own decanting statutes are considering the adoption of the Uniform Decanting Act.

Decanting is derived from the Trustee's authority and/or discretion to make distributions of income and/or principal to the beneficiaries of an irrevocable trust. At its core, the theory behind decanting is that if the Trustee has discretion to make a distribution outright to a beneficiary, the Trustee should be able to exercise that discretion to make a distribution to a beneficiary with further strings or conditions (such as in further trust). Each state that has adopted a decanting statute has slightly different requirements in order for an irrevocable trust to be decanted. Under the laws of each state that permits decanting, the common thread is that decanting cannot be used to add a beneficiary that was not a beneficiary of the original trust.

## Top 3 Reasons to Decant a Trust

There are several common reasons to decant a trust. Some of these are minor and include changing the situs to alleviate state income tax considerations. The following are what I consider the top three reasons to decant a trust.

**1. "EXTEND" THE TERM OF THE TRUST.** Many trusts distribute outright to the trust beneficiaries at staggered ages, such as one-third at age 25, half the balance at age 30, and the balance at age 35. The idea behind this outright distribution is to delay the distribution of the assets until a beneficiary's presumed maturity. However, trusts can provide a significant level of creditor, divorce and estate tax savings to the beneficiary if implemented properly.

With trusts that distribute outright at staggered ages, if a beneficiary is being sued or going through a divorce at the time of an outright distribution, the assets may become exposed to claims. Holding assets in a continuing, discretionary trust provides optimal creditor protection. Further, if a beneficiary has developed a problem (for example, drug or alcohol dependency or need for qualification for state benefits), outright distributions can be harmful. Therefore, one of the most common reasons we find to decant a trust is to allow the assets to be held for the beneficiary in continuing trust (rather than distributing outright).

*IMPORTANT NOTE:* Decanting cannot generally be used to extend the perpetuity period of an existing trust. Doing so may trigger the "Delaware Tax Trap" and therefore have immediate transfer tax consequences.

**2. CHANGING A SUPPORT TRUST INTO A DISCRETIONARY TRUST.** In certain states, exception creditors can pierce through a support trust – one that distributes to the beneficiaries for their health, education, maintenance and support - and attach the interest of a beneficiary, even if the trust includes a spendthrift clause. A discretionary trust is one in which distributions may be made in the sole and absolute discretion of the trustee, not subject to any specific standard for distribution. A discretionary trust offers a greater level of creditor and divorce protection to the beneficiaries (assuming the use of a proper distribution trustee that is not a beneficiary of the trust), and, with the exception of Florida, the remaining 49 states in the United States recognize the protections offered by a properly drafted discretionary trust. In certain jurisdictions, such as California, state income tax may be applied to a support trust if a beneficiary resides in the state. Because of the added level of creditor protection with a discretionary trust (and potentially state income tax savings), another common reason to decant is to convert a support trust into a discretionary trust. When decanting a support trust into a discretionary trust, situs selection is critical, as only six states expressly permit decanting a support trust into a discretionary trust.

**3. ADDING POWERS OF APPOINTMENT.** Before decanting, a change in family circumstances or lack of control over an irrevocable trust may have resulted in a full distribution of the trust to the primary beneficiary (thereby negating the transfer tax and creditor protection benefits of the trust). With decanting, instead of distributing the trust to the primary beneficiary, the Trustee may distribute the assets into a trust that gives the primary beneficiary a power of appointment. This power of appointment may be limited so as not to cause inclusion in the beneficiary's estate, but may be broad enough to allow the primary beneficiary to direct the ultimate distribution upon the beneficiary's death (for example, the power of appointment could be exercised by the beneficiary in favor of a person who was not a beneficiary of the original trust).

Although a properly drafted trust can provide divorce and creditor protection to the beneficiaries, if the trust is drafted to be outside the beneficiary's estate for estate tax purposes, then the assets in the trust do not benefit from a step-up in basis, even if the beneficiary does not have a taxable estate. Decanting can be used to transfer assets into a trust that provides a formula general power of appointment. This would purposely include assets in the beneficiary's estate in order to reset the basis of the trust assets (up to the estate tax exemption available in the beneficiary's estate).

## Decanting Checklist

Seeing the benefits that can be achieved through decanting, advisors must determine whether an existing trust can be decanted and, if so, whether any changes to the situs of the trust must be made in order to achieve the ultimate goal.

- **Does the trust agreement prohibit decanting?**

  Many older trust agreements do not include a specific prohibition on decanting, since it is a relatively new development in estate planning. However, as clients are implementing estate plans now, we often have clients that have very specific wishes related to their assets and beneficiaries, and do actually want to "rule from the grave." In those client circumstances, it is important to discuss decanting with the clients to determine whether a prohibition should be included in the new trust agreement.

- **Does the trustee have sufficient distribution discretion?**

  In order for the Trustee to exercise the decanting power, the Trustee must have the discretion to make distributions of income and/or principal. In certain trusts, poor drafting may prevent the exercise of the decanting power. For example, many old life insurance trusts do not allow any distributions of income or principal until the death of the settlor/insured. In these trusts, decanting would not be an option while the settlor is alive, and other alternatives would need to be used to potentially move the life insurance policy from the trust.

- **Does the state law of the current situs of the trust allow decanting? Can the situs of the trust be changed? Is the state's decanting law broad enough to achieve the desired changes?**

  A common hurdle to decanting a trust is the trust provision regarding the governing law, situs and/or principal place of administration. If the jurisdiction applicable to the subject trust is one that has not yet adopted a decanting law (or one in which the desired result of decanting cannot be achieved), then the first step is to look to the terms of the trust instrument to see if a change of situs or place of administration is permissible. If it is not permissible under the terms of the trust document, then the advisor must look to the state law of the applicable jurisdiction to see whether it has a decanting law that would allow the change of situs to the desired jurisdiction (resulting in potentially multiple decantings to get to the ultimate resulting trust) or whether the state has adopted some form of the Uniform Trust Code, which allows for either a non-judicial settlement agreement (to modify the trust to allow for a change of situs) or provides a specific statute permitting the change of the principal place of administration of the trust.

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## Conclusion

In sum, even if a client has a clean slate and has not previously done any estate planning, decanting can be a helpful tool to quell common fears that would impede implementation of the estate plan. For more information on situs selection for decanting, see Steve Oshins' Decanting State Rankings chart, available on our website at www.oshins.com.

As a result of the Tax Cuts and Jobs Act of 2017 (TCJA) the estate, gift and generation skipping transfer (GST) tax exemption amounts increased to approximately $11.18 million per person (approximately $22.36 million for a married couple). For assets transfers in excess of the applicable exemption amount and otherwise subject to such taxes, the highest applicable federal tax rate remains at 40 percent. While the exemption amounts are indexed for inflation, current law provides for an automatic sunset of these increased exemption amounts after 2025. As a result, the exemption amounts available in 2026 and beyond could be reduced to a level provided under prior law ($5.49 million/single and $10.98 million/couple in 2017, indexed for inflation) absent further action by Congress. In addition, under different rates, rules and exemption amounts (if any), there may be state and local estate, inheritance or gift taxes that apply in your circumstances. Please consult your own tax or legal advisor for advice pertaining to your specific situation. This material includes a discussion of one or more tax related topics. This tax related discussion was prepared to assist in the promotion or marketing of the transactions or matters addressed in this material. It is not intended (and cannot be used by any taxpayer) for the purposes of avoiding any IRS penalties that may be imposed upon the taxpayer. Any third party material in this newsletter represents the views of its respective author and the author is solely responsible for its content. Such views may not necessarily represent the opinions of New York Life Insurance Company or its subsidiary companies. Oshins & Associates , LLC, is not owned or operated by New York Life Insurance Company or its affiliates. The Nautilus Group® is a service of New York Life Insurance Company. Nautilus, New York Life Insurance Company, its employees or agents are not in the business of providing tax, legal or accounting advice. Individuals should consult with their own tax, legal or accounting advisors before implementing any planning strategies. SMRU 1872233-B Exp. 12/31/2020

Special Needs Planning

# Power of third-party special needs trust to provide for disabled individuals.

By Brett Thornock, JD, ChSNC®

One of the most powerful planning tools available to caregivers of an individual with a disability is the Special (aka Supplemental) Needs Trust (SNT). An SNT can help to ensure the individual continues to qualify for available government benefits while at the same time providing additional supplemental resources to allow him/her to have the quality of life which the caregiver envisions. The multitude of items that can be provided for by the SNT can help create the freedom, opportunities and options that caregivers, families and friends wish to provide their loved one both during their lifetimes and after their death.

## What is a 3rd-party SNT?

There are two primary types of SNTs, 1st party and 3rd party. A 1st-party SNT is a trust for the benefit of an individual with a disability that is funded with his/her personal assets. Whereas a 3rd-party SNT is also created for the benefit of an individual with a disability, it is funded with assets owned by anyone other than the trust beneficiary.

Both types allow for an individual with a disability to have his/her additional needs met (i.e., needs not being provided for through government benefit programs), while maintaining their eligibility for those programs. However, a key difference is that upon the death of the individual with a disability, the remaining assets of a 3rd-party SNT will typically not be subject to any reimbursement claims by the government. A 3rd-party SNT can be created in a couple of ways:

1. During the lifetime of the grantor as an irrevocable trust or a revocable trust; or,
2. At the grantor's death via a testamentary trust created in a will/revocable living trust.

Each type of 3rd-party SNT can accomplish the grantor's objective of caring for their loved one with a disability, however, creating a third-party SNT during the grantor's lifetime can provide other family members, friends, and caregivers with a vehicle to facilitate gifts or bequests for the individual. This reduces the risk that assets will be inadvertently transferred to the individual with a disability outright, which could jeopardize his/her access to government benefits.

Additionally, creating an irrevocable trust during the grantor's lifetime also provides the grantor a

mechanism to help support the individual in an estate tax efficient manner (since assets transferred to the trust are generally removed from the grantor's taxable estate).

## Distributions from a 3rd-party SNT

The provisions of the 3rd-party SNT are typically focused on only allowing for trust assets to be used to supplement the care and support of the individual with a disability in ways that are not provided for by government benefits (though there may be situations in the beneficiary's life where exceptions should be made). In fact, if certain distributions are made either directly to the individual with a disability or paid on his/her behalf in order to provide food or shelter, then the individual's government benefits may be reduced or lost. While a 3rd-party SNT should not provide direct distributions or pay for the individual's food or shelter, they always can provide for things like education, recreation, counseling, and medical attention beyond the simple necessities of life. For example, the 3rd-party SNT can cover a wide array of every day expenditures, including the following:

- Medical/dental expenses/equipment not covered (e.g., wheelchair).
- Over-the-counter medications (including vitamins or herbal supplements).
- Non-food grocery items (e.g., laundry detergent, fabric softener, deodorant, soap, personal hygiene products, paper towels, toilet paper, etc.).
- Therapy or rehabilitation services.
- Training and education (academic or recreational/hobby).
- Travel/vacation, which can include the cost of a companion (SNT cannot pay for food).
- Recreation and entertainment (summer camp, museums, zoo, movies or social events, videos, sports/fitness equipment, gym membership, music lessons).
- Electronic equipment (computer, TV, DVD, camera) and services (cable, internet, phone).
- Appliances (washer, dryer, microwave, refrigerator) and furniture.
- Legal, accounting, or guardianship expenses.
- Insurance (auto/home).
- Burial expenses.
- Pets/pet supplies.
- Transportation (a car, specially equipped van, a ride share membership, a bus/rail pass, gasoline, oil change, car maintenance).
- Help with starting a business.
- Home services (alarm system, cleaning, landscaping, maintenance).
- Dry cleaning/laundry services.

## Using a 3rd-party SNT to purchase a home

In addition to the many benefits that an SNT can be used to provide, a 3rd-party SNT may also be used to purchase a home for an individual with a disability. Buying a home through an SNT provides additional protection against creditors and allows for increased flexibility when selling the property (i.e., the proceeds would not have to be used to purchase a new home to prevent them from counting as assets of the individual for benefits eligibility).

A major benefit of an SNT owning a house is that the beneficiary may be able to live in the house rent-free without affecting his/her

Supplemental Security Income (SSI) payment. However, if the trust pays certain other expenses (electricity, heat, or water), the amounts are considered in-kind support and maintenance (ISM), and SSI is reduced dollar-for-dollar, up to $277 per month (in 2019). If the trust were making mortgage payments on the house, those payments would result in an SSI reduction up to $277 per month.

Of course, there are multiple factors that should be considered in deciding if this is an economical use of trust funds:

- Is the home itself appropriate for the beneficiary given his or her disability?
- Will housing costs consume a large part of the SNT resources?
- Will the beneficiary want/need to live in a different area in the future?

## Using a 3rd-party SNT to contribute to an ABLE account

Another powerful use of the 3rd-party SNT could be the use of trust funds to make contributions to an ABLE account. The ABLE account was created in 2014 and allows annual contributions of up to $15,000 into the account. As long as the account total does not exceed $100,000 and the funds are used for disability related expenses, the account holder's eligibility for many means-tested public benefits is not affected by the ABLE account.

One significant advantage of an ABLE account is the ability to use funds contributed to the account to pay for housing (rent, mortgage, property taxes, etc.) and household operating expenses (gas, electricity, water, sewer, garbage, etc.) without resulting in an SSI reduction.

If the payment for housing comes from the 3rd-party SNT, instead of the ABLE account, it would be considered ISM and will lower the individual's monthly SSI payments. However, if the 3rd-party SNT made those same distributions to the individual's ABLE account, the money could be used to pay for housing expenses with no reduction to SSI.

In order to ensure the trustee has the ability to make distributions from the 3rd-party SNT to the ABLE account, the SNT grantor should explore including provisions in his/her trust that grants the trustee this power.

Overall, the 3rd-party SNT can provide benefits to an individual with disabilities in numerous ways depending upon his/her needs, abilities, and resources. As always it is important to remember that the rules are very complicated, and you should consult with an attorney experienced in planning for individuals with disabilities in order to determine what is best.

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