BUSINESSDIMENSIONS

FINANCIAL STRATEGIES FOR THE ENTREPRENEUR

Trust in the future

Preserving the proceeds of a business

An estimated $30 billion to $40 billion in wealth is set to transfer from baby boomers to their heirs or favorite charities. This includes wealth tied up in a family business. As you plan for the future of your business, you may earmark the proceeds from the sale of the business to support your lifestyle, your family or a preferred charity for years to come. But it's also important to consider the potentially significant toll taxes could take. Fortunately, tools and strategies exist to help ease the impact.

THE TRUSTY TRUST

One such tool is a trust – a fiduciary relationship in which you as the grantor give a trustee the right to hold title to assets for the benefit of your beneficiary. While there are many types of trusts, here are four that are commonly used in business planning.

GRANTOR RETAINED ANNUITY TRUST (GRAT)

This irrevocable trust enables you to enjoy the proceeds from the sale of your business, then potentially pass significant wealth to beneficiaries with little or no gift tax. To create a GRAT, the grantor transfers assets into the trust and receives annuity payments over a fixed number of years. These annuity payments are calculated so that the grantor is treated as having made little or no taxable gift to the GRAT beneficiaries because, relative to

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Trust in the future (cont.)

present value, the grantor will receive back everything put in. Appreciation in the trust assets in excess of the IRS assumed rate of return eventually passes to the beneficiaries gift-tax free.

For a GRAT to be effective, two conditions must be met: First, the assets in the GRAT must grow faster than the IRS's assumed rate of return so there is something to pass along. Second, you must outlive the term of the GRAT. If not, assets will revert back to your estate. However, creating a series of short-term GRATs can mitigate some of the mortality risk.

INTENTIONALLY DEFECTIVE GRANTOR TRUST (IDGT)

An IDGT creates a complete transfer of assets to a trust for transfer-tax purposes, but an incomplete (defective) transfer for income tax purposes. Assets, such as a business, are transferred by a completed gift or a fair market value sale (or installment sale), in which both are disregarded for income tax purposes in regard to the estate.

As a result, you will no longer retain any powers that would cause estate tax inclusion, and the future value of the transferred assets is removed from your estate. Although the trust is irrevocable, it is treated as a grantor trust for income tax purposes because the grantor retains other powers. This means the grantor, though not a beneficiary, is taxed on all the trust's income, even though you would not be entitled to any trust distributions.

INCOMPLETE-GIFT NON-GRANTOR TRUST (ING TRUST)

Some states' income taxes can reach significant percentage levels. This is where the establishment of an ING trust may help. To date, ING trusts have been used for nearly 20 years and have received more than 70 private letter rulings from the IRS that the trust structure is valid.

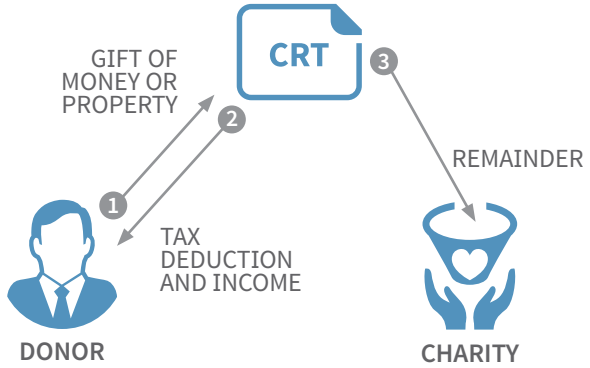
The trust is effective due to its designation as a taxpayer for income tax purposes. Therefore, the trust and trustee must be domiciled in a no-income-tax state. When business ownership is transferred to the ING trust, the transfer is not a taxable event. When the trust later sells the company, the income will be attributed to the trust, a resident of a no-income-tax state. While the proceeds and earned investment income remain in the trust, they will receive the benefits of tax savings. When the trust is requested to distribute funds, income tax is then paid to the home state.

CHARITABLE REMAINDER TRUST (CRT)

If you would like the proceeds of selling a business to benefit a favorite charity, yet also desire to receive income from the proceeds, a CRT is an option. It is, however, an irrevocable trust so once established, terms cannot be changed nor assets moved.

To establish a CRT, you would transfer business shares or proceeds from a sale to the trust. You would name yourself or another beneficiary as recipient of the income from the trust. When the terms of the trust end, the chosen nonprofit group receives the remainder. You also will receive an income tax deduction equal to the estimated present value of the remainder interest. The charity selected must be approved tax exempt by the Internal Revenue Service. The trustee is also required to maintain tax records.

THE ANATOMY OF A CHARITABLE REMAINDER TRUST



A trust in the future of your business may invigorate your trust in the future, too. Just be sure to consult with professionals to determine what works best for your personal and professional situation. ■

FIRST THINGS FIRST

In some cases, the IRS has held that trusts established after signing letters of intent violated the Anticipatory Assignment of Income Doctrine that was adjudicated by the Supreme Court in 1930 to limit tax evasion. Consult your tax, legal and financial professionals regarding the date you intend to sell your business and any estate planning or wealth transfer you wish to do around the sale.

NEXT STEPS

- Think about a time frame for the sale of your business – even if years away – and share this with your legal, tax and financial professionals
- Make a list of all parties – yourself, family members and/or nonprofit organizations – whom you wish to benefit from the proceeds of the sale
- Make sure the development of your exit plan is a coordinated effort between each member of your professional team – this will help avoid gaps in your plan

Virtual moats

Proactively protect your assets

Along with the rewards of business ownership come risks – including risk to personal assets should action be brought against your business. Insurances, diversification, smart management and good hiring are ways to protect your professional assets, but it's imperative to learn how to protect your personal assets.

DIG A MOAT

Like ancient physical moats, a virtual moat – comprising legal instruments designed to provide defense for your personal assets – can be quite formidable. While there isn't a single instrument that can be used to create a legal moat, there are several that can be deployed together to create a protective effect. Here's what we mean.

BREAK GROUND ON YOUR MOAT

Begin by separating your personal world from your professional one by making your business a standalone company. This includes choosing the type of entity your business will be; it matters.

Though popular, sole proprietorships and general partnerships leave owners liable for any company debts, judgments and lawsuits, and creditors can lay claim to both personal and business assets. For more rigorous protection of personal assets, consider the primary benefits of an S or C corporation or a limited liability company (LLC). In an S corporation, shareholders can be held liable only for the money they invest in the business, and creditors are unable to seize personal assets in the event of a lawsuit or other loss. In a C corporation or LLC, there is limited legal liability for directors, officers, workers and shareholders.

All corporate documents should be created by a qualified attorney and kept readily available. Annual maintenance includes paying the required fees to the state, holding mandatory meetings and keeping minutes. Maintain separate financial accounts for your personal life and business, and use the company name on corporate documents.

WIDEN THE MOAT

If your corporation owns property, you can add a second layer of separation between your personal assets and anyone seeking damages from an injury that occurs on the property by having the property owned by a separate LLC. Make sure the entity has a written procedure in place for fixing hazards when identified. Consult an attorney to determine if a strategy like this is right for you.

DEEPEN THE MOAT

Add depth to the moat with insurance. Rather than targeting the assets of the business, someone seeking damages can pursue the money available through insurance. Purchase the right amount and kind of insurance – type varies depending on whether you rent property, own a rental property, or operate a professional practice or retail space. A knowledgeable insurance agent can advise you on what you need and help you reassess your needs annually.

Once established, keep your moat maintained to provide years of protection while you grow your business. ■

NEXT STEPS

- Decide what business structure works best to protect you from actions against your business
- Work with professionals to build a "virtual" moat around personal and professional assets
- Talk to an insurance agent to make sure you have the right amounts and types of coverage

Ensure and enhance

Life insurance for the life of your business

Business isn't only about business; it's also about life – the owner's life and family, and the lives of employees and their families. Keeping a business – on which lives depend – vibrant and prosperous is an important part of business planning. That is why planning should always consider insurance, especially life insurance. Here's why:

BUY-SELL FUNDING

A succession plan is necessary to direct business transfer upon specific life-changing events, especially the loss of the owner. If there are partners, a buy-sell agreement supported by life insurance can eliminate the need to liquidate critical assets with ready cash on an income tax-free basis.

KEY PERSON PROTECTION

Many businesses rely on the performance or expertise of one individual. If that person dies pre-retirement, life insurance can provide income tax-free cash to supplement the critical loss in top line contributions until someone of equal skill or knowledge is hired. Key-person insurance can serve as collateral in a business loan to ensure payments are made if a performer's contributions are lost.

EXECUTIVE BONUSES

Through an executive bonus plan, the business pays the premium for a life insurance policy owned by an executive. He or she receives permanent life insurance protection that builds income tax-deferred cash value over time and the premium amount is tax deductible to the business. The premium is taxed as ordinary income to the executive, and proceeds are payable to the policy beneficiary free of income taxes.

ESTATE EQUALIZATION

When some family members are active in running a business and some aren't, trying to divide a business equally among family can set them at odds. Life insurance can provide compensation to family members not involved in running the company that is equal to the value of the business left to family members who will ultimately take ownership of the business.

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There are many ways to support your business and those who make it work. Life insurance is one of those ways that can literally pay dividends. Your advisor can help you coordinate with your legal and insurance professionals to ensure the right coverage and beneficiaries are in place to support the longevity of your business. ■

NEXT STEPS

- Speak with your advisor to learn more about your options
- Discuss the strategy of using life insurance as executive compensation with your tax professional
- If you have multiple family members who will be affected by the sale of your business, speak with your advisor about insurance to help with estate equalization