

Succession Planning: *(Continued from the previous issue)* The Transfer of Ownership and Management

The Process Of Developing A Succession Plan

Success or failure of a succession plan can hinge on sensitive and effective communication, which should be facilitated by a professional. The process for developing and implementing a plan is equally as important as the content of the plan. That process should follow the pattern of a well-managed business, where there is a vision from which objectives are derived. An action plan to achieve the objectives is developed and its results evaluated. Based on the evaluation, the process is refined. Succession planning is an ongoing process.



Often it is a trusted advisor to the business and family that can play a valuable facilitation role. However, it is important that the facilitator be prepared to engage in a meaningful, wide-ranging exploration of all the issues; not just gravitate quickly to a flavor of the month tax/financial plan. Technically correct plans that miss the mark on softer issues like family dynamics can cause irreparable harm.

The advisor must recognize that both the transferring generation and the succeeding generation have rights and responsibilities. The business owner should be free to define the conditions of his or her own retirement and continuing involvement in the business after a transfer occurs, but the owner also has a responsibility to communicate their intentions to the succeeding generation. Obviously, the succeeding generation has the right to define the level

of their involvement in the business, or they may have a lifetime aspiration wholly separate from the business. These personal plans must be communicated to the transferring generation. If members of the succeeding generation do wish to be involved in the business, they have the responsibility to demonstrate a commitment to it.

Benefits Of Having A Succession Plan

The benefits of having a succession plan in place long before the transfer of ownership is contemplated are numerous:

1. Time is available for a transition, which is important if the next generation will succeed to ownership.
2. Complications for your survivors in the event of an untimely death, including potential problems with payment of estate taxes, will be minimized.
3. The danger of a loss of value or the failure of your business also will be reduced.
4. There should not be a requirement to liquidate your business on short notice at a "fire sale" price should you die or become disabled unexpectedly.
5. Continuity for the employees who have been loyal to you and contributed to the value of the business can be assured.

Achieving these benefits can be facilitated by involving a trusted advisor. The value received from successful facilitation, intervention and guidance by a qualified advisor is immeasurable.

—Dean R. Fair, CPA

Editor's Note --- Dean is the Managing Partner of McGill, Power, Bell & Associates, LLP and specializes in manufacturing clients. Most of these clients are privately-held companies, whose owners have concerns related to succession of the ownership and management of their companies.

Philanthropic Tax Strategies

The Federal Government uses the income tax laws as a means of achieving social policies. One such application is the deduction for charitable contributions. The highest federal individual rate is 35%. The highest corporate marginal income tax rate is 39% and the state corporate net income tax rate is 9.99%. Effectively an individual can make a \$1,000 contribution that costs him or her only \$650. The same corporate gift can be made at a cost of only \$550. Effectively the government subsidizes \$350 and \$450 of the gifts respectively. Charitable gifts through a will are also heavily subsidized. The top federal estate tax rate is 46% and the top Pennsylvania rate is 15%. A \$1,000 charitable bequest in an estate could cost the estate only \$390.

There is a definite advantage to making charitable gifts during one's lifetime. The donor receives the income tax deduction and also removes the asset and income it would generate and/or appreciation in its value from his or her gross estate

Additionally, Income in Respect of a Decedent ("IRD") is subject to both income and estate taxes. Common IRD's are:

- Accrued interest on savings bonds
- IRAs
- Annuities
- Qualified retirement plans

The following example demonstrates how onerous the taxation of IRD's can be:

IRA balance	100,000
Federal estate & PA inheritance taxes	(60,000)
Balance to heirs	40,000
Income tax on IRA distribution	(14,000)
Balance received, net of tax	26,000

Contributions using IRD's can be especially beneficial. To obtain this benefit the will should specifically require that a charitable gift be funded with IRD assets. Consider naming charities as the beneficiary of a qualified plan or IRA. If at the time the donor is doing their estate planning, the value of the IRA or qualified plan and the financial needs of their spouse are both uncertain, the donor can name their spouse as the primary beneficiary and the charity as the secondary beneficiary. The surviving spouse can then disclaim the appropriate amount in favor of the charity, if they feel comfortable doing so.

If the donor plans to sell stocks or real estate to fund a charitable donation, they should consider gifting the real estate or securities directly to the Nonprofit. The capital gains tax of 15% on the appreciated value of the gift is not payable in this case. Nonprofits should establish a broker relationship to facilitate the transfer of such gifts.

These strategies for avoiding tax on IRD assets and capital gains can have additional benefits by avoiding "hidden taxes." Not recognizing this income keeps it from being included in the calculation of tax on social security benefits or affecting the Alternative Minimum Tax cal-

culatation. It also can affect the phase out rules related to itemized deductions and exemptions or the phase out rules applied to other credits, such as the education credits.

Typically, the donor or donor's beneficiary retains an income interest in the gifted assets for life or for a defined number of years.

Charitable Lead Trusts are funded with assets that provide an income stream to the Nonprofit over the donor's life or a period of years. At the end of the term, the remaining assets return to the donor or their beneficiaries.

Consider naming charities as the beneficiary of a qualified plan or IRA.

Charitable Gift Annuities involve a gift of assets to a charity in exchange for a guaranteed income stream for the life of an individual or the joint lives of an individual and a designated beneficiary. The income stream is a percentage of the donated assets, and the rates are set by the American Council on Gift Annuities. The donor receives a charitable deduction at the time that the property is donated. The calculation of the charitable deduction equals the value of the contributed property less the value of the annuity. The annuity is valued based on IRS valuation tables and current interest rates.

The annuity payments may begin immediately or may be deferred until some future date (i.e. retirement). When the annuity payments are received:

- A portion of each is nontaxable return of investment
- A portion is ordinary income, representing the earnings on the investment
- A portion may be long-term capital gain if the donor contributed appreciated property

For example a donor aged 74 contributes stock valued at \$23,469 with a cost basis of \$13,598. The donor receives an annual annuity of 6.9% (determined by the American Council on Gift Annuities) or \$1629.40 for life. In this case, the donor received a charitable deduction of \$9,615. Annual payments recognized for tax purposes are:

Income - \$561.93
Capital Gain - \$444.80
No tax - \$612.67

Charitable Remainder Trusts (CRT) are created when assets are transferred to a trust, the income from which is received by the donor or non-charitable beneficiaries for life or a term of years. At the expiration of the income interest the remainder interest passes to the nonprofit.

A fixed amount or fixed percentage of the trust's value must be paid to the non-charitable beneficiary annually. Unlike a Charitable Gift Annuity, there is considerable flexibility for

setting the annual payment. If the payments are for a fixed term, this term cannot exceed 20 years. The value of the remainder interest passing to the nonprofit must be at least 10% of the Fair Market Value of trust when it was established. A CRT is not normally taxed at the trust level. It is treated as "pass through" and taxed as the distributions are received by the beneficiaries.

The charitable deduction is calculated as the value of the property contributed less the value of the annuity or unitrust payment. The annuity value is based on IRS tables, which utilize the current AFR. The higher that interest rates are the greater the available deduction. The example below uses a \$100,000 CRAT and a 7% annuity for fifteen years.

Time of Gift	AFR	Charitable Deduction
June 2006	6.0%	\$32,000
June 2005	4.8%	\$26,400
June 2003	3.6%	\$19,900

Another planned giving instrument is a **Private Foundation**, which allows donors to accumulate, manage and disburse funds for charitable purposes, while receiving a tax deduction at the time the funds are transferred to the foundation. However, they are expensive and subject to complex restrictions and operating requirements.

Donor Advised Funds allow a donor to establish a separate fund with a specific charity or community foundation. The donor retains the right to make recommendations for using the separate fund's resources and approving grants from the fund.

Naming a charitable organization as the beneficiary of life insurance is another means of realizing a current tax deduction and providing a future benefit to the nonprofit.

It is also possible to achieve charitable intentions by giving a nonprofit a **remainder interest in a Farm or Residence**. The donor realizes

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a charitable deduction on the value of the property, and the donor and their spouse may continue to live in the residence or on the farm for the remainder of their lives.

The commonwealth of Pennsylvania provides incentive credits under the Neighborhood Assistance Credit Act. Individuals can receive a 50% tax credit for contributions to organizations that provide the following services to impoverished neighborhoods:

- Neighborhood assistance/ community service
- Comprehensive service projects
- Job training or education
- Crime prevention

The commonwealth also offers tax credits to businesses who make donations to qualifying scholarship or educational improvement organizations. The credit is 75% and as much as 90% with a two year commitment.

Both tax credit incentives are administered by the Department of Community and Economic Development.

There are many available benefits of charitable giving in addition to the charitable deduction, if the giving is accompanied by sound planning.

—Robert B. McMunigle, CPA, PFS

Editor's Note --- Bob is a Manager in the firm's Meadville office and is deeply involved in strategic tax planning, personal financial planning and estate planning. This article is based on a talk that he recently made on this subject at a seminar in Erie, Pa.



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