WINTER 2020

For Trusted Advisors

Estate Planning

Basic estate planning considerations and documentation.

By Eva Stark, JD, LL.M.

A significant number of Americans have no estate plan in place in the event of premature death. However, failing to plan can have consequences that could be very costly both financially and in terms of undesirable distributions, delay, and family disharmony.

Issues and considerations

Many considerations go into developing an effective estate plan:

- Type of assets owned.
- Overall net worth.
- Family structure and dynamics.
- Wishes and goals.

These issues, described below, should be thoroughly discussed with attorneys and financial professionals.

AVOIDING INTESTACY. A basic will can be used to ensure that assets will be distributed as desired. If an individual dies without a will—i.e., dies "intestate"—assets will be distributed as state law specifies. State law default distributions may come as a surprise to many individuals and may provide for drastically fewer or drastically more assets to certain beneficiaries than what may have been desired or anticipated.

SELECTING A GUARDIAN FOR MINOR CHILDREN. A will also can be used to nominate a guardian for minor children or their property. If a minor child has no other living parent or legal guardian at a parent's death, the court will consider and frequently appoint the person the parent nominated in the will. In the absence of a will, the court will select a guardian based on what it deems is in the child's best interest which may be different from the parent's wishes.

AVOIDING INADVISABLE DISTRIBUTIONS. A will may additionally be used to keep assets in trust for beneficiaries if outright distributions are inadvisable. It may be unwise to distribute assets to a beneficiary who: is too young or immature; is a spendthrift; has outstanding creditors; may undergo a divorce; is disabled and eligible for government benefits; or for other reasons. Keeping assets in a properly structured trust can help protect assets from third parties and help ensure that assets remain available for the benefit of the intended

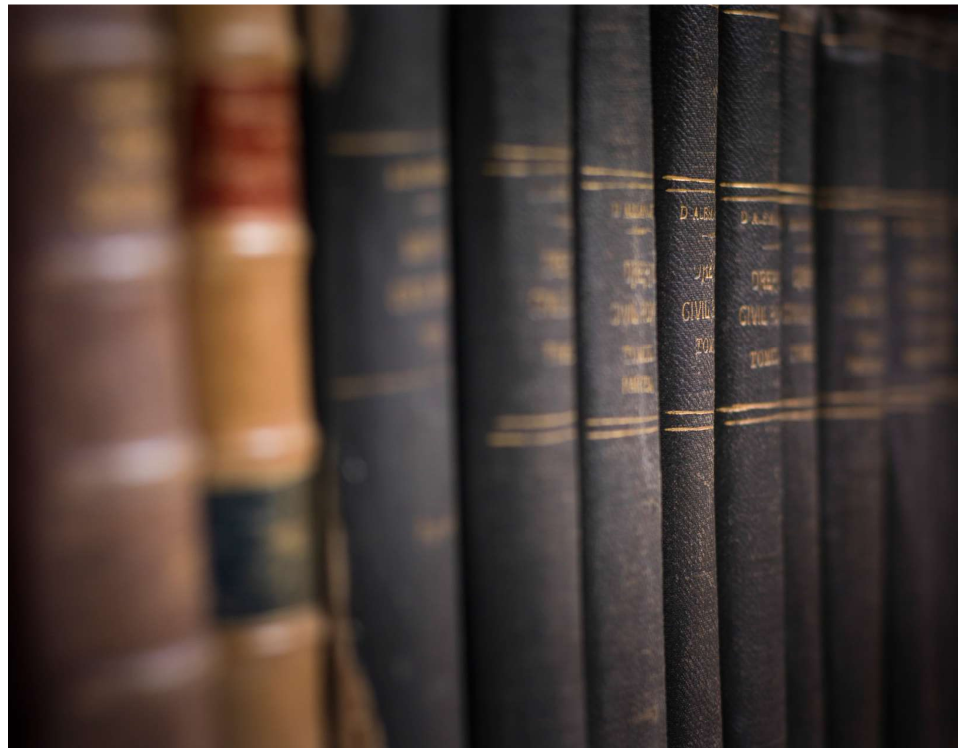
beneficiary and other family members.

CONSIDERING ESTATE TAXES. For most individuals, neither federal nor state estate taxes will be a concern. However, where federal or state estate taxes may be an issue, planning opportunities for lowering or eliminating taxes may be permanently lost in the event of intestacy.

While the federal estate tax lifetime exemption amount is currently $11.4 million, many states have a much lower state-level estate tax exemption amount. Massachusetts and Oregon—currently the states with the lowest exemption amounts—each have a state-level estate tax exemption amount of only $1 million.

REMEMBERING NON-PROBATE ASSETS. Many individuals own a substantial amount of "non-probate" assets that pass outside a will. These typically include retirement accounts and life insurance that pass by beneficiary designation, certain jointly-owned property, pay-on-death accounts and similar assets. These should be reviewed with an individual's attorney to ensure that they are coordinated with overall objectives and planning.

UTILIZING LIFE INSURANCE. Life insurance can play a critical role in estate planning. It can protect a family's financial security in the event of the death of a breadwinner or stay-at-home parent. It can help equalize children's inheritances where a significant portion of the estate is tied up in a business or farmland that may be designated to pass to a child actively involved in running the business or farm operations. Life insurance can also add much-needed liquidity to an estate for the payment of various obligations, including estate taxes.



Estate plan documents

Once an estate plan is developed, the individual's attorney will draft documentation that is in accordance with the plan. Documentation in a typical estate plan may include:

WILL. A will may be used to avoid intestacy, name a personal representative and guardian for minor children and to keep assets in trust for children and later descendants if immediate distributions are inadvisable.

REVOCABLE TRUST. For many individuals, a revocable trust (established in addition to a will), can offer additional advantages. A revocable trust can provide for privacy in the disposition of assets. While a will can become public record in certain circumstances, the terms of a revocable trust typically remain private. A revocable trust can also help avoid the need for ancillary probate in every additional state where the decedent may have owned real property. The trustee also holds and manages assets as soon as the assets are transferred to the revocable trust—not just after death. As a result, the trustee can effectively manage the assets in case of the settlor's incapacity.

Just like a will, a revocable trust also can include provisions to keep assets in trust for beneficiaries in the event that outright distributions are inadvisable.

DURABLE POWER OF ATTORNEY. An individual may become unable to manage financial affairs well before death due to old age, disease or injury. A durable power of attorney may be used to appoint a trusted individual (an "agent") to handle financial affairs under such circumstances. This can avoid a potentially costly guardianship proceeding where a court appoints a guardian it deems will act in the

individual's best interest. Where the estate includes a business, a separate document may be executed to appoint an agent for making business decisions. The document may be made effective immediately upon execution or only in the event of incapacity.

NOMINATION OF PRE-NEED GUARDIAN. In many states, it is customary for an individual to nominate a guardian for his or her person or property "pre-need" as part of his or her estate planning documents. If the individual does become incapacitated, and a guardianship proceeding is commenced, the court will consider the nominated agent. Without such a document, the court will likely appoint a close relative it deems can act in the individual's best interest.

HEALTH CARE PROXY. A health care proxy may be used to nominate a trusted family member or friend to make health care decisions if an individual is unable to make or communicate his or her own health care decisions. The document can typically be structed to take effect immediately or upon the individual's incapacity.

ADVANCE DIRECTIVE. An advance directive may be used to express a person's wishes with respect to various types of life-sustaining treatment in the event he or she becomes terminally ill or permanently unconscious and unable to communicate such wishes to his or her doctor.

HIPAA AUTHORIZATION. The Health Insurance Portability and Accountability Act of 1996 (HIPAA) protects certain health care information. An authorization may be needed to permit medical personnel to discuss such protected health information with agents named under powers of attorney.

RE-EVALUATING PERIODICALLY. Even if an individual established an effective estate plan and executed proper documentation, changed circumstances or laws may necessitate revisions. Family circumstances may change (a marriage, the death of a spouse, birth of a child, divorce, etc.). Guardians, executors or trustees named in documents may no longer be living or capable of handling duties. Tax laws may have changed. Financial circumstances and insurance needs may have changed. As a result, estate plans should periodically be re-evaluated with an individual's attorneys, financial advisor and other professionals to determine whether updates may be necessary.

OVERCOMING EXCUSES. Many individuals fail to create an estate plan. This may be due to not making time to address a seemingly far-off problem, avoiding potentially difficult conversations and decisions, not wanting to think of one's mortality and the perceived high cost of working with attorneys and other professionals.

However, the lack of a plan can lead to drastic consequences that may easily be addressed with an appropriate estate plan and the help of competent attorneys and financial professionals.

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.

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. 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 1842215-B Exp. 6/18/2021

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.

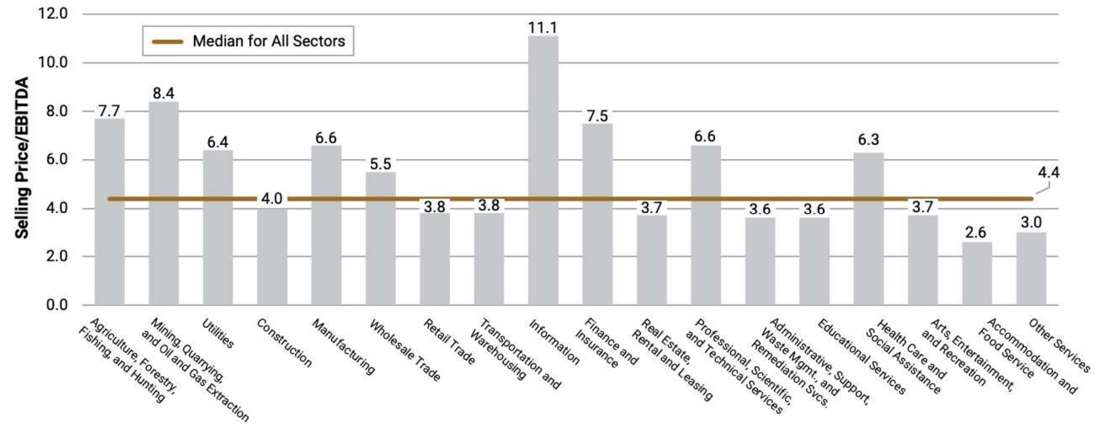
Two Categories of Value Drivers

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.

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. Wes Shelton and SM2 Advisors are not affiliated with New York Life Insurance Company or its affiliates. The Nautilus Group® is a service of New York Life Insurance Company. Nautilus, New York Life, its employees and its 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 1842215-B Exp. 6/18/2021

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.

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. 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. The cash value in a life insurance policy is accessed through withdrawals and policy loans, which accrue interest at the current rate. Loans and withdrawals will decrease the cash surrender value and death benefit. SMRU 1842215-B Exp. 6/18/2021