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Sentinel Trust[SM]

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# OnWatch


## In This Issue:

**Selecting and Using Entities — Managing the Roles**

*By Justin L. Baker, MBA, JD, LLM*

**Family Office Services — The Backbone of Private Wealth Management**

*By Katherine Rose, MBA, CFA®*

**Income Tax Opportunities for Low-Rate Family Members**

*By Brandon D. Harsell, CPA*

# *Selecting and Using Entities* MANAGING THE ROLES

Wealthy families must consider numerous factors when selecting among various types and combinations of legal entities for business, investment, and planning activities. This article addresses some of the relevant thought processes and decisions.

**Justin L. Baker, MBA, JD, LLM**

*Senior Vice President and Senior Relationship Officer*

## *Background on Entity Selection*

Choice of entity typically is a threshold question when entering a new venture. Limited partnerships and limited liability companies (LLCs) historically are the workhorse entities for family-owned investments and businesses. They avoid the double taxation of corporate earnings. (The first income tax is imposed on the corporation and the second is imposed on the shareholder when after-tax earnings are distributed as a dividend.) To avoid Uncle Sam's double dip, family-owned corporations can make an "S election" to tax earnings directly and only to the shareholders. However, the resulting so-called "Subchapter S corporation" presents additional complexities relative to partnerships and LLCs, so they rarely are the first choice for families.

**Benefits of using partnerships and LLCs include:**

- limiting owners' personal liability to risks associated with the entity's activities,
- state and federal income tax planning,
- estate tax planning, and
- coordinated management control over underlying assets and activities.

### *About Sentinel Trust Company*

*Sentinel Trust Company, LBA is an independent wealth management firm and multi-family office that provides comprehensive wealth and succession planning, fiduciary, investment management, philanthropic, and family office services to a select group of affluent families and their closely held entities and foundations. Founded in 1997 as the successor to two 40-plus-year old single-family offices, Sentinel Trust currently serves more than 30 multi-generational families nationwide and is responsible for approximately $5 billion in assets as of December 31, 2020.*

**Learn more at** *www.sentineltrust.com.*

Families also can select the best state in which to create the entity as states vary with regard to income taxation. Some are lopsided in favoring owners over management (or vice versa) and some states make it cheaper to form and administer the entity. Other states' legal systems are more efficient in adjudicating disputes and their statutes and case law are more developed.

## *Estate Planning*

Family limited partnerships (FLPs) have long been a mechanism used by affluent families to reduce the gift and estate tax cost of transferring wealth to younger generations. The typical arrangement entails placing business or investment assets into the FLP and then transferring limited partnership interests to younger-generation family members. Because the limited interests lack marketability and do not exercise control over the entity, their fair market value is discounted for purposes of determining the gift tax consequence of the transfer. How big is the discount? Depending upon the circumstances, an appraiser may apply a discount of 30% or more, thereby significantly decreasing the amount of the gift exclusions/exemptions consumed by the transfer. An LLC offers a similar discount by transferring non-managing membership interests.

Partnerships and LLCs often are used to structure management of personal-use assets like vacation homes, the family ranch and artwork. However, such assets can be problematic if the entity also is to be used to generate valuation discounts for gift tax purposes. The IRS has been successful in taxing all of the assets of partnerships/LLCs upon the senior generation's death, despite having previously transferred most of the equity interests, if the senior generation retains the right to use the assets. So, if the art hangs in the senior generation's living room or Dad hangs out at the ranch, there may be an unintended estate tax. Consequently, if an entity is to be used to provide management for personal-use assets, a different entity probably should be used for estate planning for business/investment assets.

## *Management and Control*

The general partnership or managing membership interest typically is represented by a modest (say, 1%) equity interest, while the limited partnership or non-managing membership interests typically are the lion's share (say, 99%). This structure gives the senior generation the flexibility to transfer most of the equity while retaining management control. However, the IRS has had some limited success in equating retained control over the entity with retained use of the underlying assets, resulting in estate taxation like the personal-use issue discussed above. Consult your advisors to minimize this risk.

Isolating control in a small equity interest provides flexibility to determine which family member gets control in the future. Because its value is relatively modest, that equity interest can be transferred at a future date with little gift tax consequence. The senior generation might decide to transfer the control only to the descendant(s) active in the business and/or capable of handling the associated responsibility even though the ownership of overall equity is split equally. However, doing so can adversely impact family dynamics if the result is some members feeling disenfranchised or if the successor managers abuse their control.

## *Layering Entities*

Transferring the partnership/LLC interest to a trust rather than outright to the family members offers additional benefits, albeit with additional complexity. Trusts offer:

- the potential to avoid estate tax at each generation's death (by utilizing the generation skipping tax exemption),
- protection from spouses in the event of divorce,
- protection of trust-owned assets from family members' legal liabilities,
- protection of the trust's income and assets from spendthrift heirs,
- confidentiality of trust provisions (relative to a last will and testament, which is filed in public records after death),
- avoidance of probate costs,
- succession of management (via the trustee succession provisions) in the event of family members' incapacity or death and
- continuity of ownership over multiple generations.

The selection and succession of trustees is critical. Although a family member or close friend often is named trustee (because they arguably will do whatever the family wants and won't charge a fee), a professional, independent trustee offers an additional layer of protection and insulation. This can be particularly helpful if none of the descendants have the skill or interest to be owners and/or managers of the underlying business or assets. The professional trustee can be responsible for selecting and holding accountable those who will run the business or manage the assets. The professional trustee also can act as an independent party in determining how much capital is appropriate to retain in the business vs. to be distributed to family members.

The roles of trustee can be split. For example, it is common for the trust instrument to designate a professional trustee to assume administrative responsibilities over the trust, thereby relieving family members of that specialized and burdensome task. Investment authority could be given to the professional trustee or someone else. Distribution authority often is given to the senior family member in each generation. However, several cautions are appropriate:

- For estate tax reasons, the person transferring assets to the trust typically may not be given distribution authority.
- To avoid taxation in a trustee's estate, a beneficiary's authority as trustee to make distributions to herself must be limited to her needs for health, support, maintenance and education. Furthermore, she must be prohibited from making distributions in satisfaction of her own legal obligations, including her obligation to support her children.
- Giving one family member, say a sibling, the right to control distributions to other family members (e.g., his siblings), can create great friction within the family. Would you want your brother (or aunt) deciding whether or not your spending is appropriate?

Consequently, some families prefer to give distribution responsibility to the independent trustee. To ensure responsiveness and accountability, the family, or select family members (like the senior member of each generation), may be granted the power to fire and replace the trustee with another independent trustee. Some families create yet another role, the "trust protector," to hold this power.

## *Differentiating Roles*

There are many roles inherent in these entities – owner, manager/officer, employee, trustee, trust protector – and in the family – parent, child, sibling, aunt/uncle, grandparent, cousin, etc. This fact can be helpful because it means there are many opportunities for family members to be involved. However, it also sows the seeds for confusion.

A family member who wears multiple hats with regard to the entity must walk a tightrope to avoid confusion, conflicts of interest and accusations of inappropriately controlling other members roles or lifestyles. It's not hard to imagine a TV miniseries in which the founder's "favorite" son is named trustee and president of the business. His siblings/nephews/nieces accuse him of mismanagement – failure to make appropriate distributions to other family members while taking excessive compensation for himself, for example. The lawyers make out like bandits.

Blood relationship to the founder of the family's fortune simply does not guarantee qualification for or competence in every role. Segregating and clarifying business and family roles can be important to both family harmony and business success.

Owners are responsible, possibly through a board of directors, for selecting and overseeing competent managers. Managers are responsible for the operation of the business in accordance with the owners' direction. Managers typically develop strategy, seek approval from the owners, and then execute on it. After the founder's generation, it is inevitable that the successor owners (the kids, grandkids, etc.) will have differing opinions, interests, abilities and needs. Making sure that family members only assume roles for which they are qualified can simplify matters, but it can be helpful to have an independent trustee who can act as an impartial intermediary when the beneficiaries don't see eye to eye.

Transition within a family business can be a perilous time for the family and its business and investment assets. The choice of entity and the choice of ownership of the entity can help mitigate that risk. There is flexibility to split voting control from economic benefit. The variety of roles inherent in multiple entities offers potential opportunities for family members to be involved. However, failure to differentiate roles can create confusion within both the family and business. A trust can provide estate tax savings plus a layer of stability that can be significant. While family members often assume the role, an independent, professional trustee can provide oversight and objectivity that may be missing within the family. ■

# FAMILY OFFICE SERVICES –
## *The Backbone of Private Wealth Management*

**Katherine Rose, MBA, CFA®**
*Senior Vice President,*
*Senior Investment Officer*

With ownership of wealth becoming increasingly complex, customized, and regulated, high-net-worth families often need more than investment advice. They need risk mitigation, back-office support, family governance, trust service accessibility, strategic planning, and professional implementation.

## *Risk Mitigation*

Families can be exposed to risk without knowing it. For example, they often form limited liability companies (LLCs) or corporations to protect themselves from risks posed by the businesses and assets held within the entity. However, if a family employee uses a bank account held in the LLC's name to pay the family's personal expenses, they may have unknowingly pierced the entity's "corporate veil" and exposed the family to liability. Proper entity accounting and management can provide critical protection against this risk.

**Other examples of risk management include:**

- Creating separate entities to pay household employees,
- Complying with financial/investment regulations,
- Reviewing insurance coverage; including appropriate umbrella policies and
- Analyzing security protection, including personal and cyber risks.

## *Back-Office Support*

Back-office tasks are time-consuming and burdensome. The family needs access to easy-to-read and timely reports that empower efficient and accurate decisions regarding trust and estate, investment, tax, and philanthropic planning. For example, searching for the optimal asset(s) to give to a charity involves reviewing low-basis assets and their corresponding fair market values. If values and reports are inaccurate, tax savings opportunities could be missed – a costly mistake for a family.

**Other helpful back-office support services include:**

- Consolidating reports (including investment statements, records, and asset performance),
- Recording, tracking and executing capital calls and distributions for privately-held assets,

- Organizing and consolidating tax information for CPAs and
- Paying and administering bills.

## Family Governance

Families can be reluctant to address and plan for their legacies. Processes and procedures around decision-making responsibilities, family involvement and ownership privileges are critical issues that are best addressed sooner rather than later to ensure family continuity and the success of a family enterprise. For example, parents may want to transfer ownership of an operating business equally among three children; however, if only one child shows interest in running the business, the family may need an alternative plan. The family office can discuss appropriate ownership structure and succession planning while offering opportunities for all of the children to continue to be involved in the family's legacy.

**Other family governance services include:**

- Formulating family governance frameworks (family councils and family assemblies),
- Establishing mission and vision statements,
- Creating a family board of directors, and
- Developing a family education plan.

## Trust Service Accessibility

The administrative and legal responsibilities required of a trustee are extensive. Appointing a family member or a close friend can create inter-family conflict or expose the trustee to a possible future lawsuit if the trustee unknowingly breaches his or her responsibilities. Trustees are responsible for investing trust assets, overseeing, and distributing assets to beneficiaries, preparing trust tax returns, implementing, and practicing trust accounting, disclosing information to beneficiaries when necessary, and being responsive to beneficiary questions. If the family does not have access to trust services, it may not realize a breach of fiduciary duty has occurred. A trust company has the resources to serve as trustee or co-trustee alongside a family member or a close friend. For example, a family member could choose to maintain his or her responsibility for investment decisions and appoint a corporate trustee to assist with all administrative tasks and responsibilities.

**Other trust services include:**

- Managing trust assets,
- Generating investment reports,
- Filing trust tax returns,
- Abiding by and following the terms of the trust,
- Maintaining detailed books and records of receipts and disbursements,
- Ensuring compliance with changing rules and regulations, and
- Exercising impartial judgments regarding financial matters.

## Strategic Planning

Managing family wealth is inherently complex. As families continue to form entities and trusts, transfer wealth to multiple generations, establish foundations and give assets to charities, their need for strategic and thoughtful planning beyond or in tandem with investment management grows. For example, a family member with a large taxable estate may find it advantageous to pay for a child's tuition directly to a school without using the child's 529 education-savings plan. This reduces the individual's taxable estate while enabling the investments held within the child's 529 plan to continue to grow over time. If the child does not use or need the 529 plan, the beneficiary can be changed to another family member.

**Other strategic planning services include:**

- Evaluating the transfer of real estate property to an LLC,
- Analyzing insurance coverage,
- Monitoring tax compliance,
- Analyzing trust and estate structures,
- Reviewing asset titles to ensure estate plans are consistent with the family's intent,
- Discussing asset location strategies for tax efficiency,
- Planning for post-sale liquidity, and
- Planning for future education expenses.

## Professional Implementation

Access to highly responsive and sophisticated advisors is imperative for high-net-worth families. For example, a legal entity may not be able to hold an asset due to the structure of the entity or the qualifications of the entity's limited partners. Having attorneys, CPAs and investment professionals working together to review documents, offer solutions and act on complicated decisions is invaluable.

**Other examples of professional implementation include:**

- Creating entity maps for estate plans,
- Gifting/donating low-basis/high-value assets for tax efficiency,
- Creating balance sheets and cash flow statements,
- Administering payroll for household employees,
- Titling assets to appropriate entities,
- Creating customized philanthropic reports, and
- Fulfilling the administrative and compliance requirements for private foundations.

Few family offices have all the necessary skills and personnel to fulfill such diverse needs. Hiring more people may not be a cost-effective or practical solution. As an alternative, the family's office could identify and partner with another family office or private-wealth-management firm that offers complimentary and, perhaps, more comprehensive services and solutions. Given today's complex investment, business, and family environment, supplementing your office's risk management, operational support, governance, fiduciary and other professional resources can avoid substantial costs and risks, while helping your family prosper today and over future generations. ■

# *Income Tax Opportunities for* LOW-RATE FAMILY MEMBERS

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*Senior Relationship Officer and Senior Vice President*

As children of ultra-affluent families graduate from college and transition to their careers, they may be uniquely positioned to take advantage of several tax opportunities due to their low income-tax brackets. Examples of these opportunities include trust distribution planning and the saver's credit.

## *Trust Distribution Planning*

Although trusts provide substantial estate tax and other planning opportunities, they can lead to notoriously high income taxes becase they reach 2022's top federal tax rate of 37% at only $13,450 of taxable income. Individuals don't reach that top rate until their income exceeds $539,900 ($647,850 for married filing jointly) and they don't reach the 20% long-term capital gains tax rate until taxable income exceeds $459,750 ($517,200 for married filing jointly).

A trust can transfer its taxable income to a beneficiary by making a distribution (in accordance with the terms of the trust instrument). For example, if a trust has taxable income of $100,000 (none from long-term capital gains), it could incur a federal tax bill close to $37,000. If the trust makes a $100,000 distribution to a low-bracket beneficiary, the income is allocated from the trust to the beneficiary resulting in that income being taxed at the beneficiary's lower rates. And if the trustee can't determine and distribute the income before the end of the trust's tax year? The "65-day rule" permits a trust to make a distribution up to 65 days after year-end and treat it as if it was made in the prior year. That provides time for year-end accounting and post-year-end tax minimization. Of course, the trust instrument must permit the distribution and the beneficiary's circumstances (e.g., ability to handle the responsibility of receiving and using the distribution) should be considered.

## *Saver's Credit*

Individuals may claim an income tax credit for up to 50% of contributions to regular and Roth IRAs, 401(k)s and other qualified accounts. For 2022, this percentage is reduced if adjusted gross income (AGI) exceeds $20,500 ($41,000 if married filing jointly) and phases out entirely if AGI exceeds $34,000 ($68,000 if married filing jointly). The maximum credit is limited to a $1,000 ($2,000 if married filing jointly). Despite their low income, qualifying family members can be incentivized and learn to save by a parent or grandparent making annual exclusion gifts ($16,000 limit in 2022) for use in making the retirement contribution.

Planning for low-bracket family members can save significant taxes when coupled with trust income tax planning; while the savers credit might not sound like a lot of tax savings, it can be a rationale for helping younger family members learn to save for the future. Check with you tax advisors for details and additional opportunities. ■

Sentinel Trust Company is a family-owned, multi-family office focusing on the unique needs of affluent families and their closely held companies and foundations. Sentinel Trust provides advice on investment, tax, and estate strategies, serves as corporate trustee, and provides lifestyle services with a personal touch.

*Together, families prosper* SM

Founded in 1997 as the successor to two established, investment-focused single family offices, Sentinel Trust offers the stability of an institutional firm, the entrepreneurial spirit of a young firm, the personal feel of a family office, and the in-house technical skills of independent planning and investment management firms.



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