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# Estate Planning for the Family-Owned Business

## Effective Strategies for Business Transfer Through Inheritance, Gift or Sale

TUESDAY, JUNE 28, 2011

1pm Eastern | 12pm Central | 11am Mountain | 10am Pacific

Today's faculty features:


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# Estate Planning for the Family-Owned Business

Effective Strategies for Business Transfer Through Inheritance, Gift or Sale
Strafford Publications
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Scott M. Nelson, CPA & J.D.

LOMMEN ABDO
LAW FIRM

# Transferring the Closely-Held Business

I. Methods to Transfer Interests
II. Succession Planning for Different Business Structures
III. Active/Non-Active Family Members in Business Succession
IV. Importance of Business Valuations
V. Buy-Sell Agreements
VI. Income and Gift Tax Considerations
VII. Funding Sources

# Business Succession Planning:

Assisting closely-held business to structure an orderly transition of:

Management

&

Ownership

# Why is Business Succession Planning Important?

- 95% of American businesses are family-owned.
  - Family-owned American businesses generate 40% of the Gross National Product.
  - 35% of the 500 largest companies in the U.S. are family-owned.
  - Only 28% of family-owned businesses have a succession plan.
- Only 57% of owners of family controlled businesses intend to transfer the business to family members.
- Only 30% of family businesses survive into the second generation!

# Why Is It Important…

- More than 50% of business owners have more than half of their wealth tied up in their business.
- One-third of family business owners are 61 or older.
- 71% of business owners over age 65 indicated that they would continue working indefinitely.

# Why Is It Important…

- FACT:  33% of all 35-year olds will be disabled for 90 days or more before reaching 65.  How can you prepare for this?
  - Identify interim leadership and management should you become disabled.
  - Determine income needs during period of disability.
  - Estimate your disability insurance needs.

# Importance of Business Succession Planning

- For the owner-managed business, planning is essential to:
  - Ensure the survival - - and the growth - - of the business.
  - Preserve family harmony.
  - Minimize taxes.
  - Facilitate retirement.

# 10 Qualities of Healthy Family Business

- Shared Values
- Shared Power
- Traditions
- Willingness to Learn and Grow
- Activities for Maintenance
- Genuine Caring
- Assistance and Support
- Mutual Respect
- Healthy Interpersonal Boundaries
- Privacy

# Family Business Inventory

| The Business of the Family | The Business of the Business |
| --- | --- |
| • Trust, Fairness and Family Connecting<br>• Quality of Family Life<br>• Communication and Resolving Conflict<br>• Balancing Self and Family Interests<br>• Individual Growth and Development | • Business Direction and Planning<br>• Progressive Management<br>• Family Participation<br>• Family-Business Boundaries<br>• Ownership and Management Continuity |

# Methods to Transfer Interests

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# Methods to Transfer Interests

- Inheritance
- Gifting
- Sales
- Charitable Donations

# Methods to Transfer Interests

- Common Objectives:
  - Ensure business will pass to family members
  - Save taxes
  - Minimize credit exposure
  - Maintaining control
  - Treat inactive children fairly
- It often takes a combination of strategies to fully achieve the client's objectives.

# Methods to Transfer Interests

- TRUIRJCA of 2010 has changed how we should approach business transfers, at least temporarily.
- Because estate, gift and generation-skipping tax exemptions are up to $5 million for 2011 and 2012, great tax-saving opportunities exist.
- However, the writing is perhaps on the wall for certain favorite “loopholes” (such as short-term GRATs and FLPs).

# Methods to Transfer Interests
## Common Strategies

- Inheritance
  - Provisions in Revocable Living Trust
- Gifting
  - Direct Inter-Vivos Gifting
  - Fractional Interests
  - Estate Freezing
  - Taxable Gifting
- Sale
  - Buy-Sell Agreements
  - Direct Sales
  - Installment Sales
  - Sales to Trust
- Charitable
  - Charitable Remainder Trusts
  - Charitable Lead Trusts

# Inheritance
## Methods to Transfer Interests

- It is best to establish the client's basic estate plan before implementing other planning techniques in case of unanticipated death or disability.
- Revocable Trust
  - Passes ownership of interests without court intervention.
  - Coordinates succession plan with governing documents of business.
  - Prepares family for unexpected triggering events.
- Irrevocable Trust
  - Grantor trust can transfer wealth to next generation at a leveraged cost.
  - Nongrantor trust can help exclude life insurance proceeds from and provide replacement funds to the estate

# Gifts
## Methods to Transfer Interests

- Before implementing any gifting strategies, the owner's personal needs must be addressed.
- Try to implement gifting strategies in order of simplest to most complex.
    1. Annual exclusion gifts as well as gifts for education and medical expenses are not taxable.
    2. Lifetime gifts up to exemption are added back to donor's estate when calculating estate tax liability.
    3. If successful, estate freezing techniques remove property from estate without gift or estate tax.
    4. Lifetime gifting above exemption amount is preferred to waiting for death since gift tax is tax-exclusive while estate tax is tax-inclusive.

# Sale
## Methods to Transfer Interests

- Buy-Sell Agreement
- Direct Sale to Beneficiaries During Lifetime
  - Outright for Cash
  - Paid in installments with or without annual forgiveness
- Sale to Intentionally Defective Grantor Trust (IDGT)
  - Paid in installments through promissory notes
  - Paid with self-cancelling installment notes (SCINs)
  - Paid through private annuity

# Charitable Donation
## Methods to Transfer Interests

- Includes direct gifts to public charities, private foundations, pooled income funds, etc.
- Split-interest trusts
  - Charitable Remainder Trusts give present income interest to non-charity for life, then to charity at death
  - Charitable Lead Trusts operate in reverse – income to charity for life, then to non-charity at death
  - Best used with low-basis assets
  - ILIT typically used for wealth replacement
  - Watch out for prearranged sales. IRS will disregard gift if trust asset is sold too soon.

# Succession Planning for Different Business Structures

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# Succession Planning for Different Business Structures

- Sole Proprietorships
- General Partnerships
- Limited Partnerships
  - Family Limited Partnerships (“FLPs”) follow family partnership rules stated in I.R.C. § 704(e).
  - Limited Liability Partnerships limit the liability of limited partnership’s general partner (“GP”)
- Limited Liability Companies (“LLCs”)
- S Corporations
- C Corporations

# Succession Planning for Different Business Structures

- Key Family Business Owner Issues:
  - Liability
  - Control
  - Ownership restrictions
  - Transfer restrictions
  - Taxation
  - Estate Planning

# Succession Planning for Different Business Structures

- For estate planning purposes, it is helpful to choose the proper entity by first looking at the intended exit strategy and its consequences.
- A combination of entities may be needed to fully achieve the client’s objectives.

# Succession Planning for Different Business Structures

## Liability

- Because owners of sole proprietorship or general partnership have unlimited liability for the entity's debts and obligations, such structures are rarely recommended for family business owners.
- General partners of FLPs should seek protection from unlimited liability.
  - Restructure FLP into an LLC.
  - Make C Corporation or an LLC the general partner of the FLP.
  - Make an irrevocable trust the general partner of the FLP.

# Succession Planning for Different Business Structures

## Liability

- Under state law, owners of the remaining business structures have limited liability. However, creditors can still assert liability on these grounds.
  - Piercing the Corporate Veil
  - Personal conduct
  - Personal guaranty of loan
- Also look to nature of business to see entity's exposure to liability.

# Succession Planning for Different Business Structures

## Control

- Owner must own over 50% of C Corp and S Corp to maintain control.
- Control of FLP is held by GP, even if GP’s share is just 1% of the entity.
- Similarly, the manager of an FLLC controls the entity regardless of the percentage of ownership.

# Succession Planning for Different Business Structures

## Ownership Restrictions

- S Corporations have several restrictions:
  - No more than 100 shareholders
  - No ownership by a non-resident alien
  - Only certain types of trusts can own the entity, including:
    - Qualified Subchapter S Trusts (QSSTs) – see  I.R.C § 1361(d)
    - Electing Small Business Trusts (ESBTs) – see I.R.C. § 1361 (e)
- FLPs, LLCs and C Corporations have relatively few ownership restrictions.

# Succession Planning for Different Business Structures

## Transfer Restrictions

- C Corporations are freely transferable.
- S Corporations are more limited because the sale to any non-qualified owner will cause the entity to lose its “S” status.
- FLPs and LLCs can be further limited.
  - There is no ready market for minority interests in these entities.
  - FLPs and LLCs can be drafted to require 100% partner or membership approval for liquidation or sale.
  - This is desirable for owner who wants to keep business in the family.

# Succession Planning for Different Business Structures

## Flexibility

- “Check-the-box” regulations enable FLPs and multi-member LLCs to choose whether to be taxed as a C corporation, an S corporation or a partnership.
- This election is made annually, so beneficiaries have ability to make necessary changes easily.
- FLPs and LLPs can be drafted to change style of management at certain events, provide control that differs from ownership structure, etc.

# Succession Planning for Different Business Structures

## Taxation

- Covered in greater detail later, but some basic rules are introduced.
- Step-up in basis at owner's death
  - Corporations allow step-up in outside basis for the value of the underlying stock, but not for the underlying assets.
  - FLPs and LLCs (taxed as partnership) can elect to step-up a decedent partner's share of assets. I.R.C. § 754.

# Succession Planning for Different Business Structures

## Taxation

- Beware! The IRS has successfully attacked FLPs and LLCs in the following cases. As a result, assets were included in the decedent's estate.
  - Grantor retained an interest or control over assets. See, for example, *Estate of Charles L. Reichart*, 114 T.C. 144 (2000).
  - Commingling of partnership and personal assets. *Id*.
  - Entity formed on deathbed. See Estate of Elizabeth B. Murphy, 60 TCM (CCH) 645 (1990).
  - Annual exclusion gifts rejected.
    - *Christine Hackl*, 118 T.C. 279 (2002), *aff'd*, 335 F.3d 664 ($7^{th}$ Cir. 2003).
    - *Walter M. Price*, 99 T.C.M. 1005 (2010).
    - *Fisher v. United States*, 2010-1 U.S.T.C. 60,588 (S.D. Ind. 2010).

# Succession Planning for Different Business Structures

## Estate Planning

- Clients often wish to make gifts of stock to minors or spendthrifts into trust to limit their ability to receive distributions or manage the entity.
  - Since S Corporations only allow one class of stock, all distributions must be made proportionally to all shareholders.
    - Additionally, the gift to trust must be to a QSST, which is required to distribute the income to its beneficiaries anyway.
- With FLPs and LLCs, distributions can be made to certain classes of partners or members.

# Active and Non-Active Family Members in Business Succession

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# Active and Non-Active Family Members in Business Succession

- Common Objectives:
  - Provide for owner’s lifetime needs
  - Avoid conflict
  - Treat all family members fairly
  - Develop next generation to run business
  - Incentivize next generation

# Active and Non-Active Family Members in Business Succession

## Issues and Possible Solutions

- Options to Provide for Owner's Retirement Needs
  - Consulting Agreement
  - Deferred Compensation
  - Sell business to children for installment note
- Second Spouse + Children From First Marriage
  - QTIP Trust (if business produces income)
  - Agreement that business is separate property
  - No-contest clause
  - Don't leave everything  to second spouse
- Prevent Conflict Between Children
  - Provide outsider with deciding vote
  - Split business up amongst children
  - Buy-sell agreement with call and/or put option

# Active and Non-Active Family Members in Business Succession

## Issues and Possible Solutions

- Active and Non-active Children in Business
  - Gift or sell voting shares to actives and non-voting shares to non-actives
  - Gift or sell business assets to actives and non-business assets to non-actives.
  - Give greater share of business or estate to actives who built business.
- Children Not Ready to Run Business
  - Recapitalize into voting and non-voting stock
  - Provide criteria that must be met before children can get voting shares
  - Create Board of Directors that includes next generation, but keeps control of business with owner.

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# Disposition of the Business

A. Buy-Sell Agreements
B. Sales/Loans to IDGTs
C. GRATs
D. Transfer of Business Opportunities
E. Preferred Partnerships and Carried Interests
F. Insurance Owned by an ILIT
G. GST Tax Planning
H. Income Tax Deduction for Trust Administration Expenses
I. Charitable Lead Annuity Trusts (“CLATs”)
J. Charitable Remainder/Lead Trusts
K. Sec. 302 Stock Redemption

# BUY-SELL AGREEMENTS

- **A buy-sell agreement is a contract drawn by legal counsel that establishes a procedure for redeeming or buying out an ownership interest in a closely held business upon the occurrence of a specific event.**
  - Financial Security
    - Guaranteed market
    - Reduce financial risk for departing owner
  - Business Protection
    - Eliminates deceased owner’s family participation
    - Lends certainty to disposition of business
    - Avoid disruption in business management

# Nature of Buy-Sell Agreements

A. Overview
B. Types of Buy-Sell Agreements
C. Mandatory or Optional Buyout
D. Methods of Determining Purchase Price
E. Common Payment Terms
F. Conflict of Interest

# Benefits of Buy-Sell Agreements

A. Creation of Ready Market
B. Continuity of Management
C. Fixing Business Value for Death Tax Purposes

# Factors to Consider in Choosing Type of Buy-Sell Agreement

A. In General
B. Tax Basis of Remaining Business Owners
C. Tax Treatment of Payments Received by Seller
D. Insurance Considerations
E. Marital Property Considerations
F. Relative Advantages of Entity Purchase and Cross Purchase Agreements

# Transfer Restrictions

A. Reasons
B. Types and Validity
    1. § 2703 – Stock Restriction Agreements
    2. Absolute Restrictions on Transfer
    3. Unanimous Consent of Other Business Owners
    4. Right of First Refusal
    5. Option to Purchase
C. Methods
    1. Articles of Incorporation
    2. Corporate Bylaws
    3. Shareholders' Agreement
    4. Partnership Agreement
    5. LLC Operating Agreement

# The Stock Restriction Agreement and §§ 2703-2704

A. Bona-fide Agreement.
B. Not a device to transfer property to the natural objects of the transferor’s bounty.
C. Comparable to similar arm’s length arrangements.
D. Price is fixed or determinable.
E. Restrictions operate during lifetime and upon death.
F. Must require (a) mandatory, or (b) sale at the option of, others.
G. § 2704 – restrictions on transferability.

# Use of Life Insurance

- **Buy-Sell Agreements**
  - Cross Purchase
  - Stock Redemption/Entity Purchase
  - One-Way Buy-Sell
- **Split-Dollar Funding**
- **Funding with Earnings Distributions**
- **Irrevocable Life Insurance Trusts**
- **Funding the Estate Plan**

# Income and Gift Tax Considerations

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# Tax Planning

A. Deferred Payment of Federal Estate Taxes: I.R.C. § 6166
   1. In General
   2. Qualification Requirements
   3. Closely Held Business Defined
   4. 35% Test
      i. In General
      ii. Strategies for Meeting Test
   5. Election by Personal Representative
   6. Personal Liability of Personal Representative

B. Redemption of Stock to Pay Death Taxes: I.R.C. § 303

1. In General
2. Qualification Requirements
3. 35% Test
4. Limit on Redemption Amount
5. Limit on Whose Stock is Redeemed
6. Time Limits
7. Use of Promissory Note
8. I.R.C. § 303 Redemption Agreement
    i. Introduction
    ii. Form

C. Adjustment to Basis of Partnership and LLC Property: I.R.C. § 754
   1. In General
   2. Election

D. Special Use Valuation of Certain Real Property
   1. In General
   2. Qualification Requirements

# Impact of Section 2701

A. General
B. When the Section Applies
C. How the Section Works
D. Exceptions
E. Practical Impact

# Donative Transfers

A. General
B. Testamentary Gift
C. Inter Vivos Gift
D. Annual Exclusion and Unified Credit
E. Revaluation of Gifts
F. Leveraging Gifts

# Problems and Opportunities in Gifts of Business Interests

A. Retained Voting Power - § 2036(b)

B. Gift to Key Employee - § 83

C. Planning
   1. Non-voting Stock
   2. Annual Exclusion
   3. Unified Credit
   4. Chapter 14
   5. Uncertainty of Valuation

# Special Challenges of S Corporations

A. One Class of Stock
B. Limitations on Trusts as Shareholders
   1. Grantor Trusts
   2. Testamentary Trusts
   3. Voting Trusts
   4. Qualified Subchapter S Trusts (“QSST”)
   5. Electing Small Business Trusts (“ESBT”)

# Installment Sales of a Business Interest

A. Goals
B. Outright Sale
C. Installment Sale
D. Sale to a Related Party
E. Installment Obligations

# SCIN and Private Annuity

A. Self-Cancelling Installment Note ("SCIN")
B. Private Annuity
C. Installment Sale and SCIN
D. Sale vs. Gift

# Stock Redemption or Sale to an ESOP

A. Sale/Gift and Stock Redemption
B. Tax Attribution - § 318
C. Stock Redemption
D. Strategies
E. Sale to ESOP

# IMPORTANCE OF BUSINESS VALUATIONS

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# *Roadmap*

- What is a Business Valuation?
- Why Conduct a Business Valuation?
- Methodologies of Business Valuations.
- Preparing for a Business Valuation.

# *What is a Business Valuation?*

- A process by which the value of a business is determined.
- The concept of fair market value (FMV) is central to the process.
- A business valuation utilizes different and additional methodology than a financial statement in order to determine FMV.
- What will my business sell for in the market?

# *Why Conduct a Business Valuation?*

- To prepare for a sale or transfer of business assets.
  - Asset Purchase Agreements
  - Mergers and Acquisitions
- To prepare for selling shares or membership interests in the business and drafting Buy-Sell Agreements.
- To prepare for retirement and/or winding down and dissolving the business.
- To plan and prepare for current and future income, gift, and estate tax.

# *Why Conduct a Business Valuation?*

- To prepare for the future development of your business by tracking market value over time.
- To adequately determine insurance needs.
- To prepare for offering employee stock plans.
- To prepare for divorce.
- To prepare for litigation.
  - External and Internal
- To prepare for compliance reporting.

# *Why Conduct a Business Valuation?*

- What is common to all of these circumstances:
  - Business valuations are utilized in the course of preparation and planning for the future of a business.
  - Business valuations are in indispensable tool in planning the fundamental development of a business and preparing for key events, such as interest transfers and sales.

# Methodologies of Business Valuations

Three Primary Approaches:

- Asset Approach
- Market Approach
- Income Approach

# Asset Approach

- Adjusts assets and liabilities to FMV.
- Assets – Liabilities = Net Asset Value.
- Include all assets in determination.
  - Not just assets on financial statement.
  - However, calculation of intangible assets is difficult.
- Perhaps not the best method for calculating going business concerns (value of business looking forward).

# Market Approach

- Seeks to establish value of business by utilizing market comparisons.
- What have similar businesses sold for relative to a comparable variable (sales, net income, earnings, etc.)
- Requires the existence of other like-kind business for proper comparative calcuations.
- Utilize database and trade organization information.

# Income Approach

- Values company by estimating future earnings and converting the estimate into a present value.
  – Based upon investor's required rate of return and risk of investment.
  – Net cash flow is typical measure of earning power.
- Attempts to quantify the concept that the true value of a business lies in part upon future earnings and wealth.

# Preparing for a Business Valuation

- Allocate sufficient time prior to the need of the business valuation.
- Locate a certified and accredited professional.
  - Attorney
  - CPA
  - Certified Valuation Analyst
- Bookkeeping and accounting should be in order.
- Be prepared to educate the professional regarding the unique characteristics of the business.
- Work with your professional in a transparent and forthright manner.

# Stock Redemption
# vs
# Cross-Purchase Agreements

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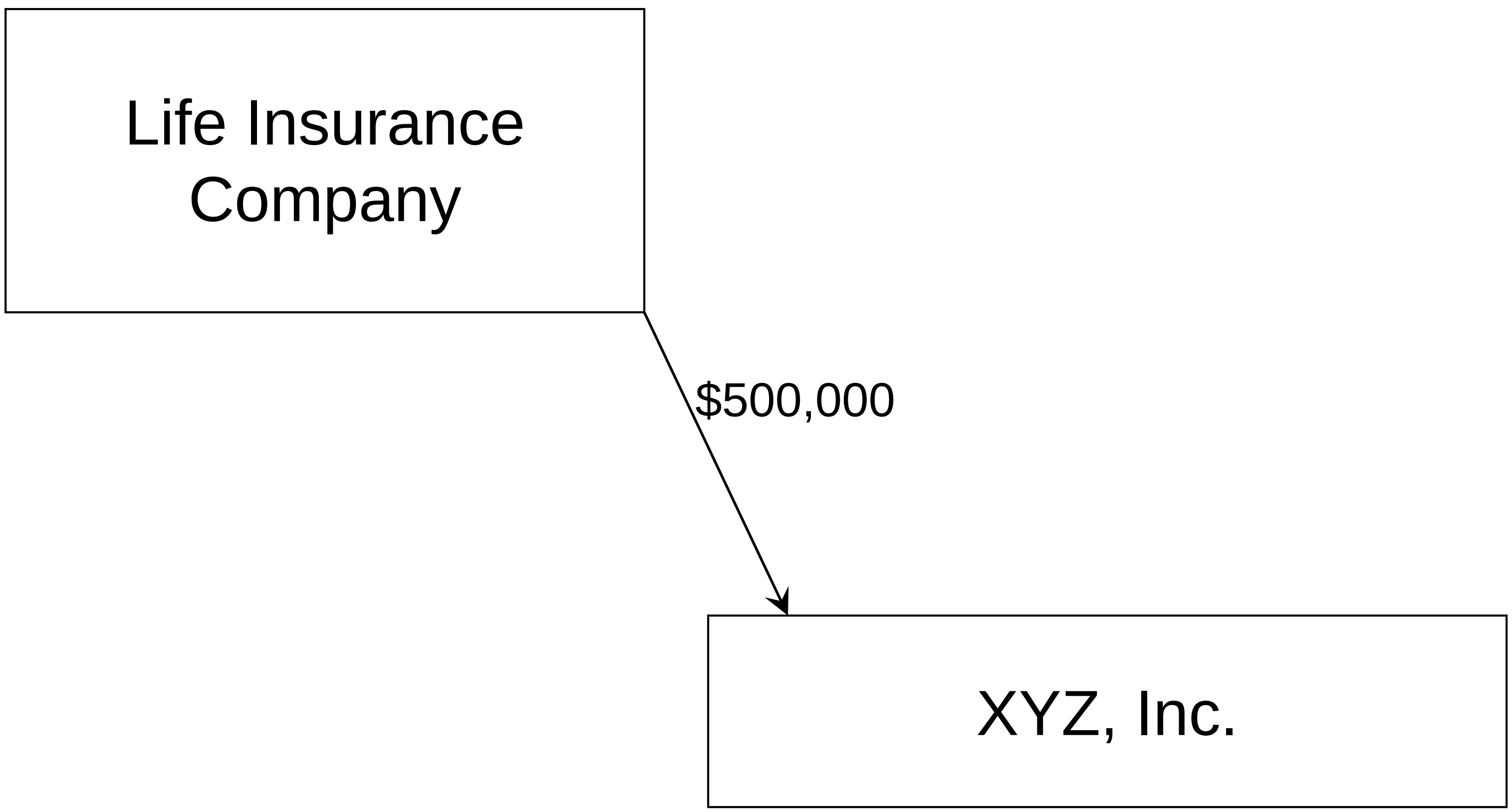
# Facts

# Stock Redemption Agreement

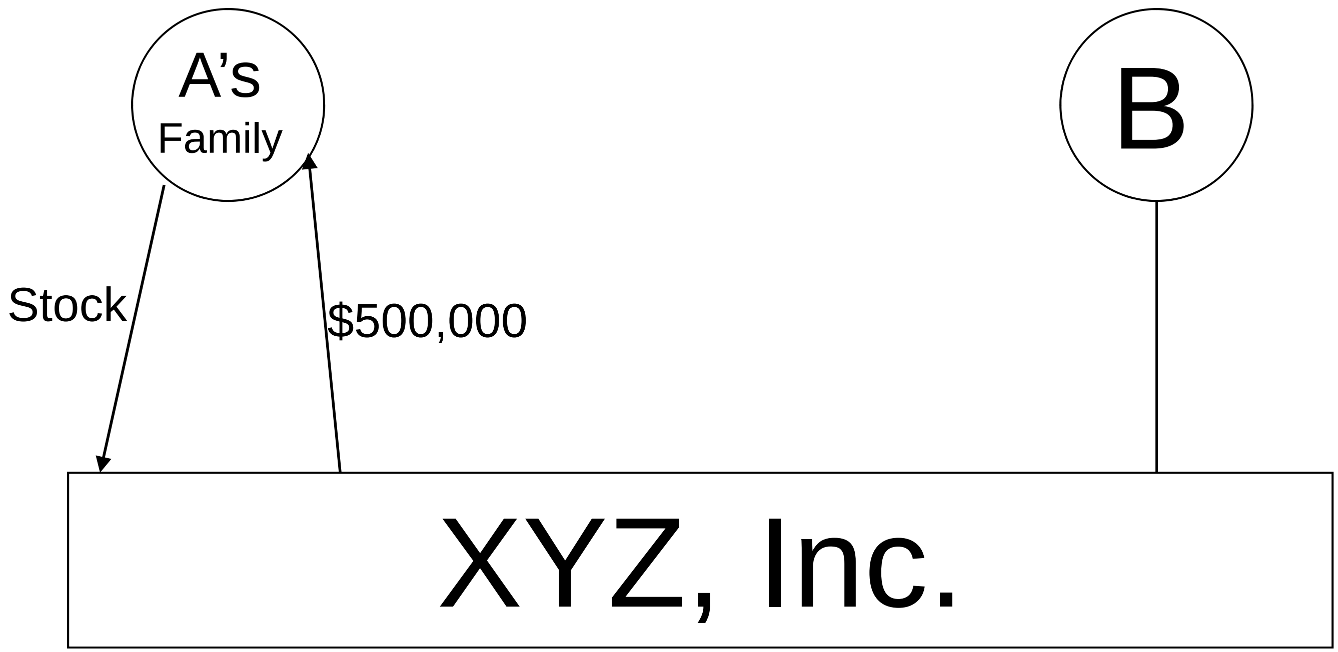
| | Policy #1 | Policy #2 |
|---|---|---|
| • Insured | A | B |
| • Owner | XYZ, Inc. | XYZ, Inc. |
| • Beneficiary | XYZ, Inc. | XYZ, Inc. |
| • Death Benefit | $500,000 | $500,000 |

# Stock Redemption Agreement

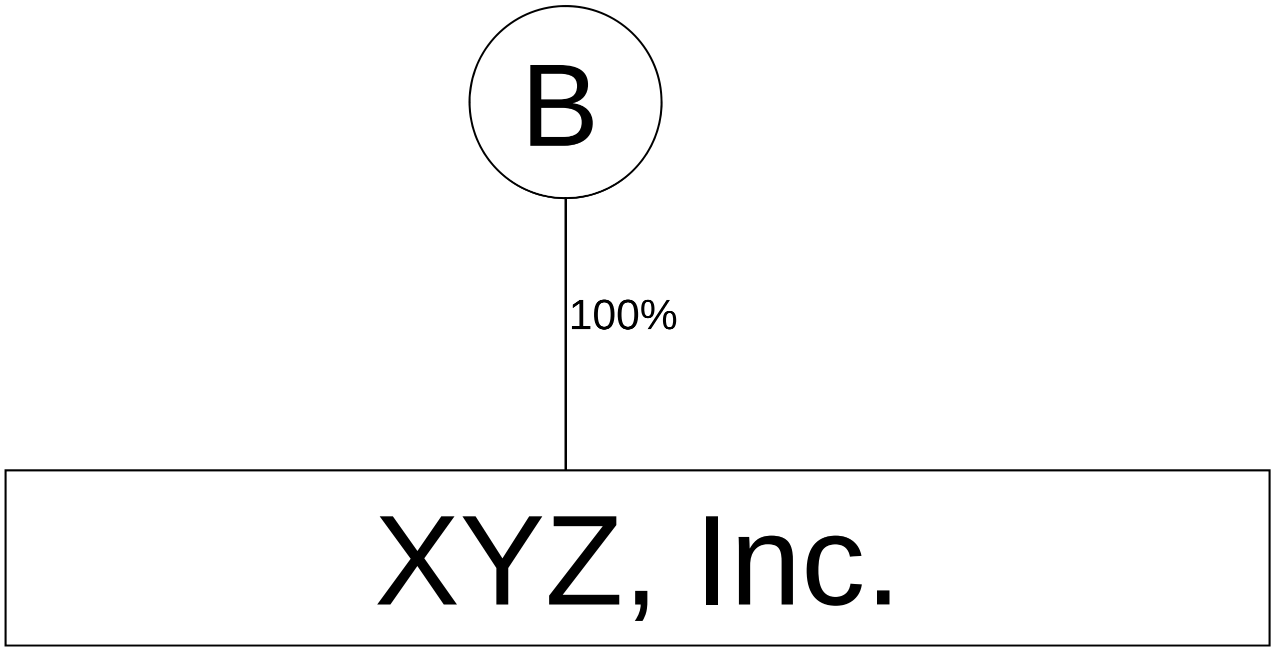
**A Dies**



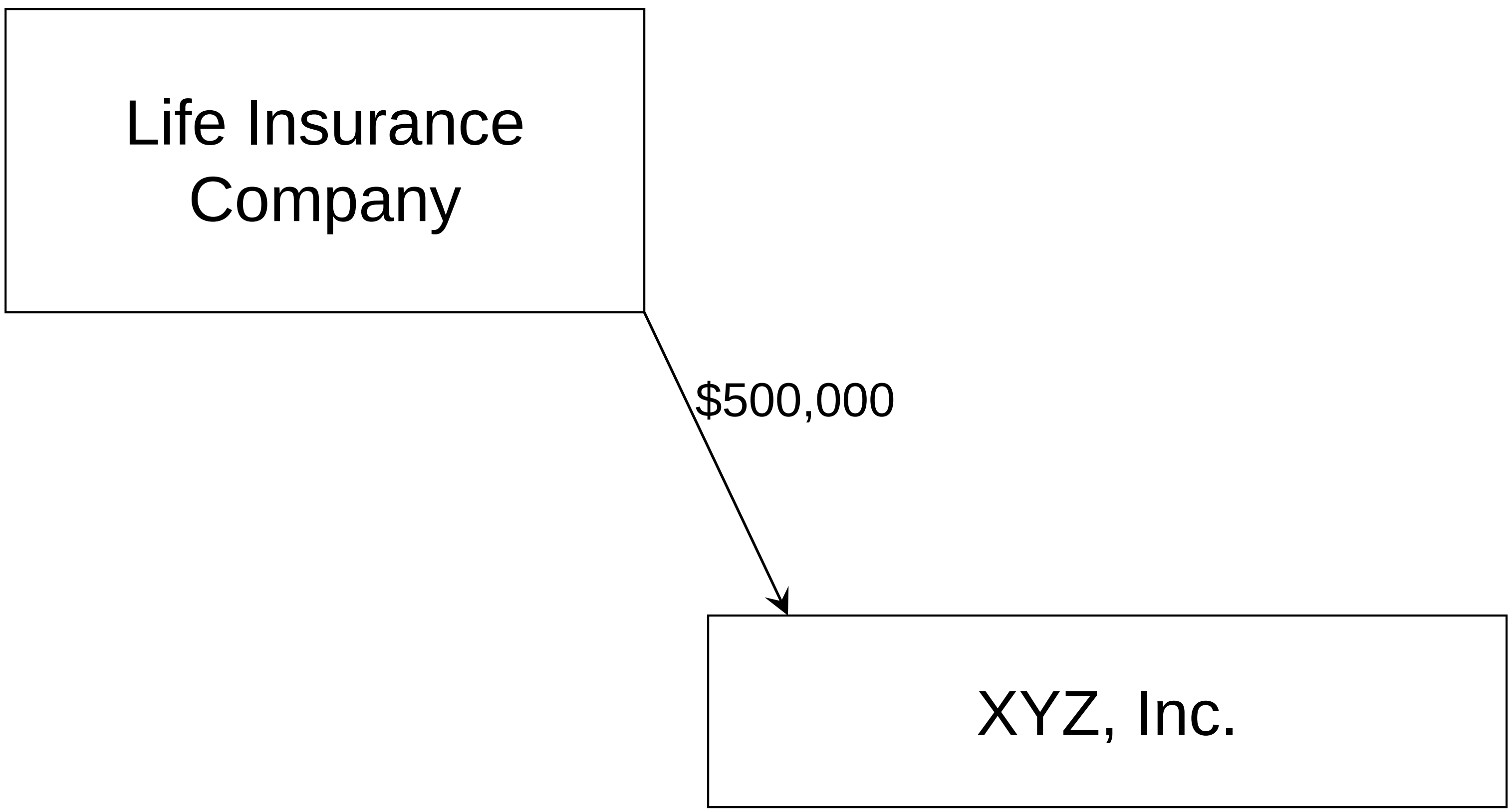
# Stock Redemption Agreement Effectuated



# After Stock Redemption



# B Dies



# Results Stock Redemption Agreement

## A's Family

$500,000 Cash

## B's Family

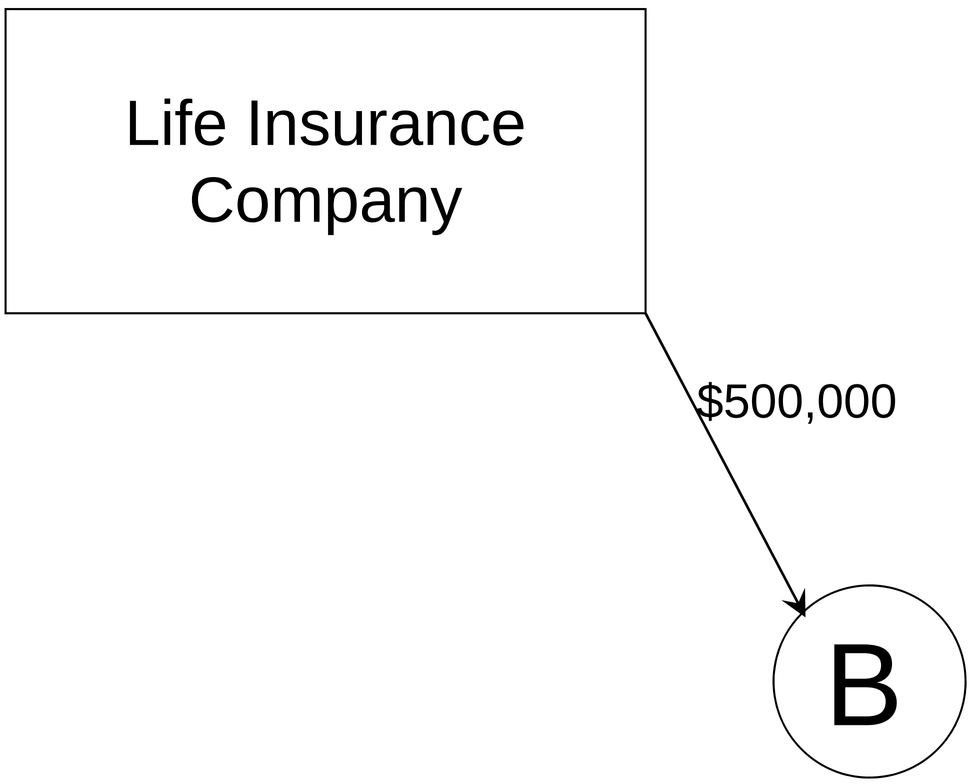
$1,000,000 Company

$500,000 Cash inside company

# Cross-Purchase Agreement

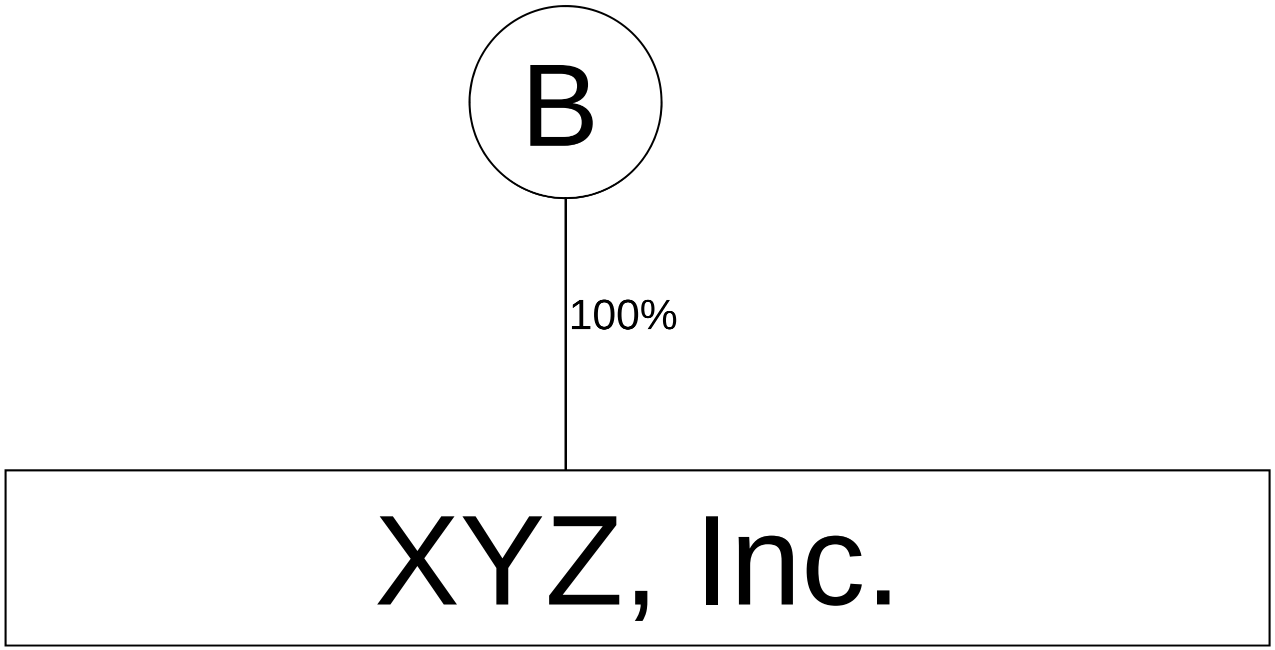
| | Policy # 1 | Policy # 2 |
|---|---|---|
| Insured | A | B |
| Owner | B | A |
| Beneficiary | B | A |
| Death Benefit | $500,000 | $500,000 |

# A Dies

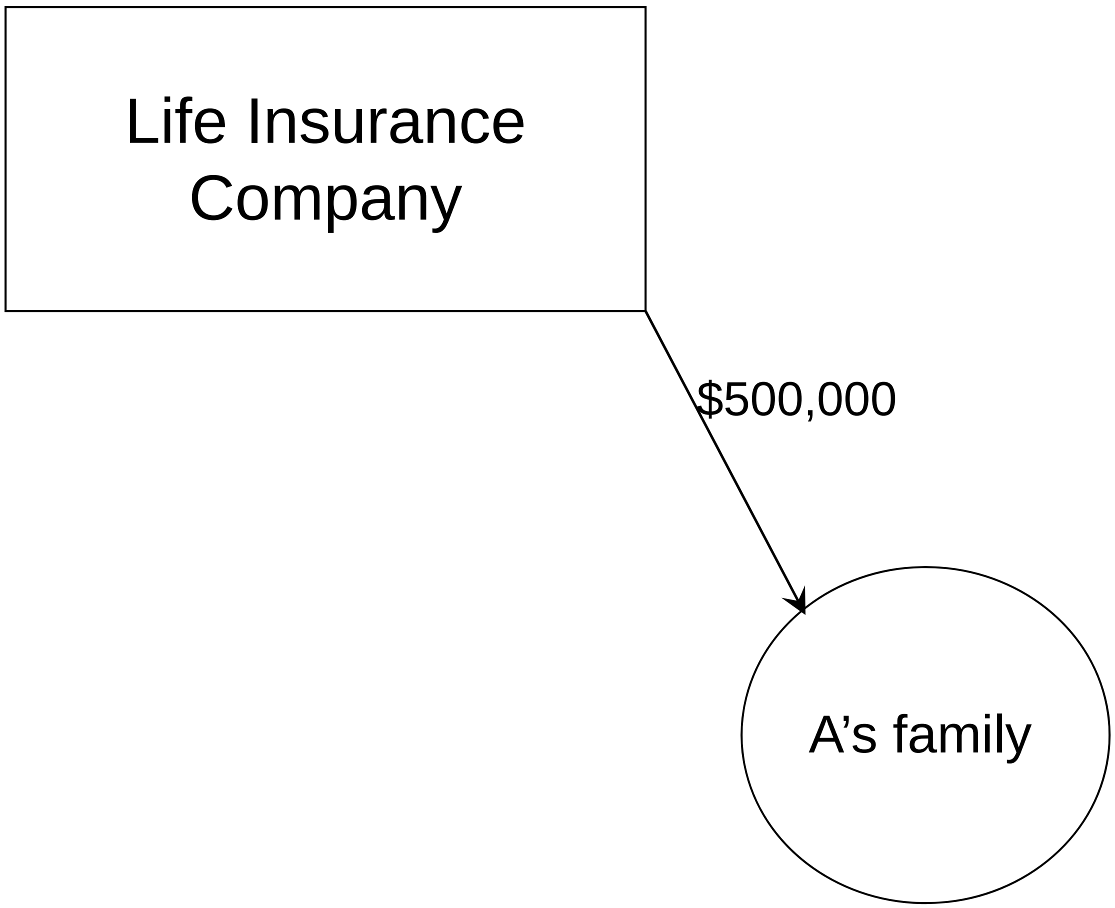


# Cross-Purchase Agreement Effectuated

# After Cross-Purchase Agreement Effectuated



# B Dies



# Results of Cross-Purchase Agreement

## A's Family

$1,000,000 Cash

## B's Family

$1,000,000 Business

# Other Considerations

## Stock Redemption Agreement

- No Step Up in Basis
- Potential AMT tax if paid to C Corporation

## Cross Purchase Agreement

- Survivor receives step up in basis
- Insurance proceeds received tax free

# When are Stock Redemption Agreements funded with Life Insurance worthwhile?

- Numerous Shareholders
- Too costly for each shareholder to buy numerous policies as required under a cross-purchase
- Last person standing (his/her family) is the Big Winner

# *Roadmap*

- What is a Buy-Sell Agreement? (Review)
- What Triggers Action in a Buy-Sell Agreement?
- Importance of Funding Sources for Various Contingencies.
- Funding Sources.

# *What is a Buy-Sell Agreement?*

- A binding executory agreement amongst co-owners requiring a departing owner to sell his interests in a business and the remaining owner to buy the departing owner's interests.

# *What Triggers Action in a Buy-Sell Agreement?*

- Whenever a co-owner departs the business.
- Examples:
  - Withdrawal of a co-owner at a time before retirement.
  - Retirement
  - Disability
  - Death
  - Bankruptcy
  - Divorce or Familial Separation
  - Loss of necessary license

# Items to Consider With Every Valuation

- Subject
- Purpose of Report
- Standards of Value
- Premise of Value
- Scope of Engagement
- Sources of Information
- Assumptions and Limiting Conditions
- Did they consider the economy, industry, and the specific company
- Challenge Subjectivity
- Statement on Standards for Valuations Services #1

# *Importance of Funding Sources for Various Contingencies*

- At a fundamental level, a Buy-Sell Agreement is inherently useless if there is no available method for the remaining owner to purchase the departing owner's interest.
- A business owner should consider various sources of funding for the various contingencies that could trigger action under a Buy-Sell Agreement.

# *Funding Sources*

- Savings
  - "Cash is King."
  - Best source of funding because it can cover all triggering events.
- Life Insurance Policies
  - Generally, each co-owner will own policy and pay premiums.
  - Payable upon death, therefore is intended to assist with only one of the triggering events.
  - Benefits may be distributed free from income tax.
  - Certain types of policies may generate cash-value, which could be utilized for other triggering events.

# *Funding Sources*

- Disability Insurance
  - Generally, each co-owner will own policy and pay premiums.
  - Payable upon occurrence of disability.
    - Ensure that covered disabilities match definition in Buy-Sell Agreement.

# *Funding Sources*

- Bank Loans
  - If co-owner is credit worthy, bank loans provide flexibility to fund all triggering events.
  - More difficult to obtain in this economy.
  - Will likely require securitization of business and perhaps personal assets.
  - A co-owner needs to re-visit his ability to obtain a bank loan on a yearly basis to ensure ability to obtain, or otherwise obtain and maintain a revolving line of credit.

# *Funding Sources*

- Promissory Note/Installment Payments
  - If allowed, terms should be set forth in the Buy-Sell Agreement.
  - Beneficial to the remaining owner.
  - May not be beneficial to remaining owner or remaining owner’s estate.
  - Promissory Note should be secured with business and/or personal assets of remaining owner.

# Questions to Ask

- Have you defined your personal goals and vision for transfer of ownership and management?
- Is your successor identified, ready and in place?
- What is the importance of family involvement in leadership and ownership of company?
- Are you currently using techniques to mitigate or eliminate estate taxes?
- Do you have enough liquidity to avoid the forced sale of your business?

# Questions…

- Do you have buy/sell agreement in place?
- Have you had your business valued recently?
- Do you have a contingency plan should you become disabled?
- Have you considered alternative corporate structures of stock transfer techniques to help you achieve your succession goals?
- Are you dependent upon your business to meet your retirement cash flow needs?