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MetLife®

Transferring the Family Business

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I. Introduction

Most financial professionals know successful owners of family businesses who accept the need for proper succession planning, yet continue to procrastinate in taking timely action. These owners often recognize that failing to plan for their own exit can create undue financial burdens for the business, its employees and especially the owner's family. Yet, their fear of losing control of day-to-day business operations, combined with uncertainties about how to best provide for their families, often results in formidable resistance. This article outlines the various issues and strategies that need to be addressed when developing a plan for transfer of the family business to the next generation.

One of the primary issues in planning for the exit of a business owner is for the owner to recognize that he or she needs to begin a transition process that allows the business owner to let go of control, so business family members active in the business may step in. Ideally, this process would begin early by focusing on creating an investment portfolio that is independent from the business. This transition of ownership may take years to accomplish and is comprised of many facets. In addition to the psychological change, the financial impact of estate and transfer taxes can be a heavy burden in planning for the transfer of the family-business.

II. Primary Objectives

The first question that should be asked is whether the business should remain in the family or should it be sold. As simple as this question sounds, it is not asked or answered until it is too late. Often, this question is not asked because it requires the business owner to make an objective assessment of a child's ability to manage the business. The owner needs to think carefully about the talent and experience required to carry on a successful business, and whether or not these qualities exist inside the family. Failure to address this issue can result in a business being retained in the family when it would be better for the family, as well as for the business, if it were sold and the proceeds distributed to the heirs.

Once the decision is made to retain a business within the family, three primary objectives need to be addressed in order to have a successful transfer to the next generation:

First, there is a need to identify and develop a plan to transfer control of the business to the children or relatives who are active in the business.

Second, in most situations, the business owner wants to treat the children who are not involved in the business in an equitable fashion.

The last, and possibly the most important objective, is for the plan to assure that the business owner and his or her spouse that they can retire in comfort without being financially dependent on the business.

Once business owners accept the need to address these three requirements, the financial professional is well along in overcoming the owner's resistance to planning. It will be important to assure that the owner fully understands the advantages of addressing each of these concerns. In most situations, the success of the business succession plan will be judged by how well these three objectives are met.

Transfer Control to the Children Who Are Active in the Business

Once the decision is made that a business will remain in the family at the retirement, disability, death or withdrawal of an owner, a formal succession plan can be developed. The main objective of planning for business continuity for the family business is to transfer the ownership to the active members of the next generation with the least amount of estate transfer costs. In most cases the principal expense is the gift and estate tax payable on transfers of business interests to family members. If a successful business owner waits until his or her death to transfer the business, his or her estate may lack sufficient cash to meet these obligations, forcing the estate to liquidate the business. This failure to plan could result in an undue financial burden on the business and may jeopardize its future viability.

Transferring the business to the surviving spouse is often the simplest approach. This approach may appear attractive initially because all estate taxes are deferred until the second death. However, leaving the business to a spouse who has no working knowledge of the business could jeopardize its ongoing success, and even threaten the spouse's financial well-being. Another problem with this approach is that family friction may arise if the spouse begins to assume a management role formerly performed by the children. Also, the fact that control of the business will not shift until the death of the surviving spouse may act as a disincentive for the children who are active in the business. Even if all of these obstacles are overcome and the business remains successful, the future growth of the business will be included in the surviving spouse's estate. This will add to the costs of transferring ownership to the next generation.

Equitable Treatment of Inactive Children

The business should not be used to equalize the estate with inactive children. Rather, the business should pass to the active children and non-business assets should be used to treat the inactive children equitably. Equitable does not necessarily mean equal value. It could be argued that a cash gift is worth more than a bequest of an equal value of closely held stock, since the stock carries greater risk and will generally require the child's active involvement in the business.

In many cases where the business is the primary asset, it may be necessary to purchase life insurance in order to provide additional non-business assets to meet this objective. This insurance could be owned by an irrevocable trust designed for the benefit of the inactive children. The death benefit could remain in the trust and be used to purchase non-business assets from the surviving spouse's estate and thereby, provide cash to pay estate taxes. The provisions in the trust could be coordinated with the owner's will to provide roughly equal (or equitable) after-tax benefits to all family members. For example, at the client's death, any trust created under the will could be merged with those created under the insurance trust.

Ideally, the children active in the business should receive the business interest and the inactive children receive other property of comparable (or at least equitable) value. In many cases, however, this may not be possible given the value of the business interest in relation to the total estate. In addition to or as an alternative to purchasing life insurance, the owner may wish to consider recapitalizing the business to create voting and nonvoting common stock. The voting common stock can pass to the children active in the business, and the nonvoting common stock can pass to the children who are not active in the business.

While it is possible to gift a nonvoting business interest to inactive children or to a trust for their benefit, it is critical that there be a market for their stock at some point in the future. This would enable the inactive children to share in the growth of the business that is a result of the efforts of the owner/parent. The business owner's will or trust could then direct that any voting stock pass to the active children and a shareholder's agreement could provide that the inactive children have the right to put (or sell) their stock to the active children upon owner's death. Insurance needed to fund the purchase of the inactive children's stock can be owned by and made payable to the active children. At the owner's death, the active children will receive the death proceeds and use them to purchase the nonvoting stock from the inactive children.

Financially Independent of the Business

Owners are often reluctant to release control of the business because their professional egos and financial well-being are so closely aligned with the business. When a senior family member's retirement and financial security are too closely tied to the continued success of the business, it will be practically impossible for that older family member to trust the leadership skills of the new generation.

Not enough attention is given to planning for the owner's financial security separate and apart from the business. More focus should be placed on creating an estate for the owner that is independent from the business. For example, business real estate should be held in a limited liability company, outside the business. In addition, greater use of retirement vehicles, both qualified and nonqualified, as well as establishment of sound investment programs outside the business would assure a smoother ownership transition when the children are ready to assume control of the business.

Unfortunately, many times it may be too late or it simply may not be possible to create an estate outside the business. In this case it will be necessary to provide income to the older generation using the business itself. If the client is still involved with the business a salary continuation plan can be established to provide a steady stream of income at retirement, disability or death. If the owner is not employed in the business, he or she can be provided (i) director's fees for serving on the business' Board of Directors; or (ii) fees for providing consulting services. If the business has assets it uses which are outside the business (e.g., equipment, building), the property can be leased to the business. The business obtains a business deduction and the payments are ordinary income to the owner.

III. Ways to Shift Control

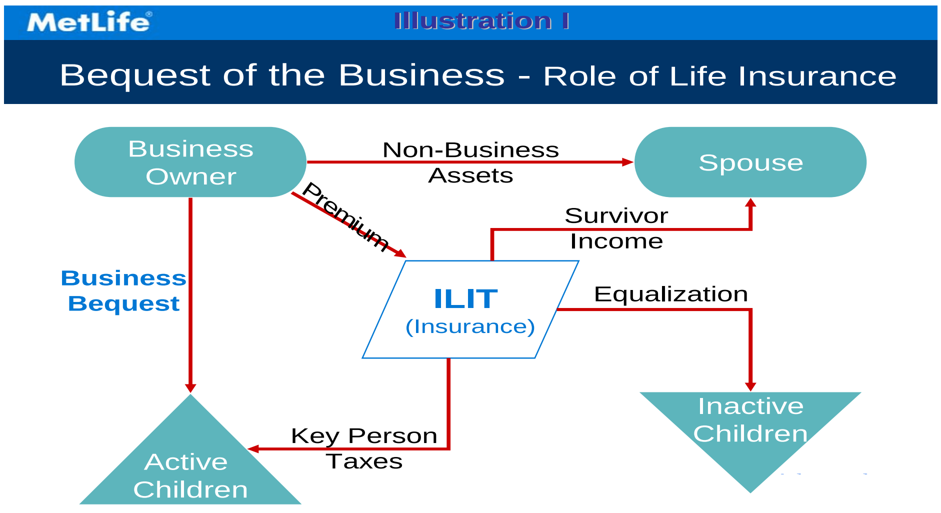
It is not uncommon to find that the business succession plan for many closely held family businesses is built around the marital deduction. At the death of an owner, his or her business interest will typically be transferred to the surviving spouse because this transfer is sheltered from federal and state estate tax by the marital deduction. This type of planning may work for owners that have spouses who are active in the business, but is not suitable for most situations.

Where the spouse is not active in the business, control of the business should shift to the children who are active in the business upon the business owner's death. A business owner can use one or more of the following types of strategies to transfer his or her business interest:

(1) Bequest

Often, the easiest solution for a closely held business is to simply bequeath the business to the children who are active in the business. This technique allows the business owner to retain control of the company while he or she is living. While the children receive the business interest with its basis stepped up to its fair market value, the full value of the business would be included in the owner's estate. This inclusion in the estate is the primary disadvantage of a bequest as all of the future growth of the business is included in the gross estate, with little or no opportunity for any valuation discounts.

The will or revocable trust can direct that the beneficiaries pay any estate tax generated by the bequest. Life insurance could be owned by the active children and used to pay these taxes. This strategy assumes, however, that there are sufficient non-business assets to maintain the spouse's standard of living and provide an equitable inheritance for the children who are not active in the business. Where this is not the case, life insurance could be owned by and payable to an irrevocable trust designed to benefit the surviving spouse during his or her life, and then at the spouse's death, pass the remaining trust property to the children who are not active in the business.



(2) Gift

Planning for business succession is an ever-changing process. For a business that is experiencing rapid growth, a well-designed plan today can become obsolete in a few years. The transfer tax costs of passing the business to the next generation must be controlled if the business owner is to realize his goal of keeping the business in the family.

Purchasing additional insurance may not be feasible if the amount needed more than doubles in less than ten years. Often, the solution to this problem is to implement an aggressive gifting strategy designed to limit the future growth in the estate. The owner can still maintain control of the business by limiting the total gifts to 49% or less of the outstanding shares or by recapitalizing the company into voting and nonvoting stock and giving the nonvoting stock.

One significant disadvantage of making gifts is that the gifted stock is acquired at the owner's cost basis and not at its fair market value at the time of the gift. If the children later sell the business interest, any gain over the basis would be subject to capital gain taxes. In addition, to the extent that the value of the gift exceeds the sum of the owner's annual exclusion amounts and the owner's applicable exclusion amount, the owner would be subject to gift tax.

On the other hand, one of the advantages of gifting is the ability of the donor to take advantage of various valuation discounts. The courts recognize that the value of a closely held business is often depressed because there is no ready market for the sale of its stock. In addition, if the gift represents a minority interest in the business, an additional discount for lack of control is also permitted. Courts have typically allowed a marketability discount and a minority discount, with the two discounts totaling between 20% and 40%.[1] For gift tax purposes, the value of the gift including any discounts for lack of marketability and lack of control should be supported by an independent and professional appraisal.

Under prior law, the IRS could revalue any gift at the donor's death, as the statute of limitations did not toll on prior gifts. The 1997 Tax Act limits the IRS's ability to challenge the gift tax valuation provided the gift was "adequately disclosed" on a gift tax return.[2] "Adequate disclosure," as required by the gift tax regulations, should be made on the gift tax return so that the three-year statute of limitations can run.[3]

Use of split interest gifts can often provide additional leverage (or discount) for valuing one's gift. For example, the owner can gift his or her business interest to a grantor retained annuity trust (GRAT) or a grantor retained unitrust (GRUT). In a GRAT, the business interest is irrevocably transferred to a trust in exchange for the trustee's promise to pay an annuity to the grantor for a fixed term of years. In a GRUT, the business is irrevocably transferred to a trust in exchange for the trustee's promise to pay a fixed percentage of the trust assets to the grantor each year. After the term of years, any remaining property in the trust passes outright to the children or to a trust for their benefit.

The GRAT is often preferred over a GRUT because the GRAT does not require annual valuations of the trust property. The GRAT could be funded with "S" corporation shares,

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[1] See Rev. Rul. 93-12, 1993-1 C.B. 202

[2] IRC § 6501 (c) (9)

[3] Treas. Regs. 301.6501 (c) -1(e)

limited liability company interests or family limited partnership interests. If the transferred interests generate sufficient income to pay the annuity and are expected to appreciate over time, such interests may be appropriate assets to fund the GRAT. Even with the lower 15% tax on dividends, however, "C" corporation stock is generally not an attractive asset to fund a GRAT, as its dividends are subject to a double layer of taxation. For example, if the "C" corporation were in a 34% income tax bracket, the combined federal income tax on the dividend would be 49% since dividends are not deductible.

The primary advantages of the GRAT are that it enables the owner to retain an income interest in the business for a period of years as well as obtain a double discount and achieve even greater transfer tax savings. Not only does the grantor obtain valuation discounts for lack of marketability and for lack of control, but the GRAT also discounts the gift because the children do not receive the trust assets until the term of years expires. Today's lower interest rates make the GRAT an even more attractive vehicle to transfer the business interest. Unlike the installment sale, the GRAT is also attractive in that it enables the owner to transfer the business to the next generation without incurring any additional income taxes.

A GRAT should not be considered if the owner is not in good health. In order to remove the business interest from the donor's estate, the donor must survive the term of years. If the donor dies before the end of that period, the Service will treat the trust as a retained interest and include the value of the trust in the donor's taxable estate.[4] Another disadvantage of the GRAT is that the generation-skipping tax exemption amount cannot be allocated to the GRAT until the donor's interest terminates.[5] Since the value of the GRAT will generally be significantly greater at that time, such an allocation would not be efficient. Therefore, the GRAT should not be used if the remainder interest passes to a generation-skipping trust.

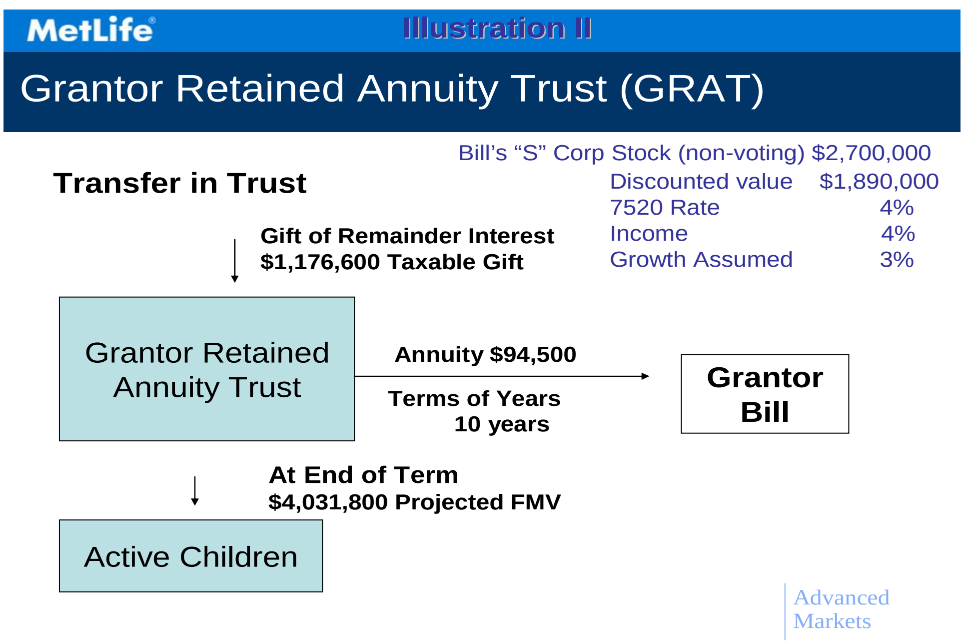
The following example illustrates how a GRAT can tax efficiently pass the value of a closely held business interest to the next generation.

> *Bill, age 60 is the founder and sole shareholder of Marvel Printing, Inc., an "S" corporation recently appraised at $3 million. Bill is married to Susan and Bill and Susan have four adult children, two of whom work in the business. The business generates about $130,000 of K-1 income. Bill and Susan want to retire next year and move to Florida. They are concerned about how to transfer the business, provide equitably for their children who are not in the business and assure adequate funds for their retirement.*

[4] IRC § 2036 (a)(1)
[5] IRC § 2642 (f)

Bill elects to recapitalize the stock of his “S” corporation into 10% voting and 90% non-voting shares. Bill then transfers all of the non-voting shares to a GRAT. (In order to obtain a minority discount two GRATs shoud be established, one for each child) Assuming a total discount of 30% for lack of control and lack of marketability, the independent appraiser values the non-voting shares at $1,890,000 ($2,700,000 less the $810,000 valuation discount). The GRAT pays Bill an annuity of $94,500 (5% of $1,890,000 - the initial value of the trust) for ten years. At the end of the term the non-voting shares pass to the children who active in the business. Assuming a Section 7520 rate of 4%, the value of the remainder interest (i.e., the taxable gift) is $1,176,600. Bill and Susan can split the gift and each use a portion of their applicable exclusion amount. Assuming the non-voting shares will generate an income of 4% and will annually appreciate over the ten-year term at 3%, the value of the trust property passing to the children in ten years will equal $4,031,800.

In order to provide equitably for their two children who are not active in the business, Bill and Susan establish an irrevocable life insurance trust for the benefit of their two children who are not active in the business. The trustee purchases a $3 million survivorship policy, which can be funded by Bill and Susan’s annual exclusions, using a portion of the annuity.



Another variation of the gift is the transfer of business opportunities. This technique is often used where the facts suggest that there is a reasonably predictable chance of success or where negligible seed money is required. Consideration should be given to having any new business opportunity owned by the active children or even better, by a generation-skipping trust (GST) from the start. The parent could loan funds to the active children (or trust) to start this venture, but should not retain any control over the business. The parent’s liability should be limited to his or her investment.

Where the chance of success is not so predictable, the “Opportunity GRAT” should be considered.[6] The Opportunity GRAT provides a means for a parent to fund a venture for a child and shift the upside gains to the child. At the same time, the opportunity GRAT offers the parent downside protection where there is a significant risk of economic failure.

(3) Sale

Another technique to transfer the business is for the owner to sell his or her business interest to his or children who are active in the business. Selling the interest to a family member over time may not, however, be attractive. Typically, the children would make payments on the installment note with earned income from the business. If family members are the purchasers, the rate of interest on the note may be set at the lowest rate that can be used without giving rise to imputed interest under IRC Section 7872. Interest on the installment note is ordinarily paid no less frequently than annually. The seller can place a security interest in the property sold. This earned income will be subject to ordinary income, unemployment and social security tax. After the children pay these taxes, the parent will then pay a capital gain tax upon receipt of the proceeds, plus ordinary income tax on any interest paid. In addition, care must be taken so that the selling price is not less than the business’ fair market value. If so, the difference would be deemed a gift by the IRS. A professional appraisal of the business should be obtained to support the sale price and a gift tax return should be filed to adequately disclose the sale and begin the tolling of the statute of limitations.[7]

Sale to A Defective Grantor Trust

To minimize these income taxes, the business interest could be sold to the business owner’s intentionally defective grantor trust (IDGT). A defective grantor trust allows one to take advantage of the differences between the estate tax and income tax rules. By including certain provisions in the trust, the trust is made defective in that the grantor remains liable for the income taxes of the trust. When the grantor pays the income tax on the trust’s income, the grantor is able to make, in essence, a tax-free transfer from his or her estate. Furthermore, a sale by the grantor to his or her own grantor trust will generally not result in current taxation on any gain because the grantor will not recognize income on a sale to himself or herself.[8]

The trust is effective, however, for estate tax purposes, as transfers to the trust are considered completed gifts and any transferred assets as well as any future appreciation on those assets are removed from the grantor’s estate. Only the remaining

[6] See Oshins Jones and Lunn, Estate Planning, March 2006, p.20, “The Opportunity GRAT ‘OPGRAT’ Can Reward Success and Minimize Adverse Tax Risk”
[7] Treas. Regs. 301.6501(e)-1(e)
[8] Rev. Rul. 85-13, 1985-1 CB 184

balance of the note that the grantor receives in exchange for the business interest would be included in his or her estate.

A sale to a IDGT works best where the business interest generates sufficient cash flow to pay the interest (and possibly reduce the principal) on the note and where the business is a pass through entity such as a "S" corporation, partnership or limited liability company so as to avoid a double layer of tax on distributions. A sale to a defective grantor trust should be considered where the business is growing rapidly and where there is a need to freeze the value of the business in the owner's estate. Insurance on the grantor's life is often owned by the IDGT so that the death proceeds can be used to repay the note at the grantor's death.

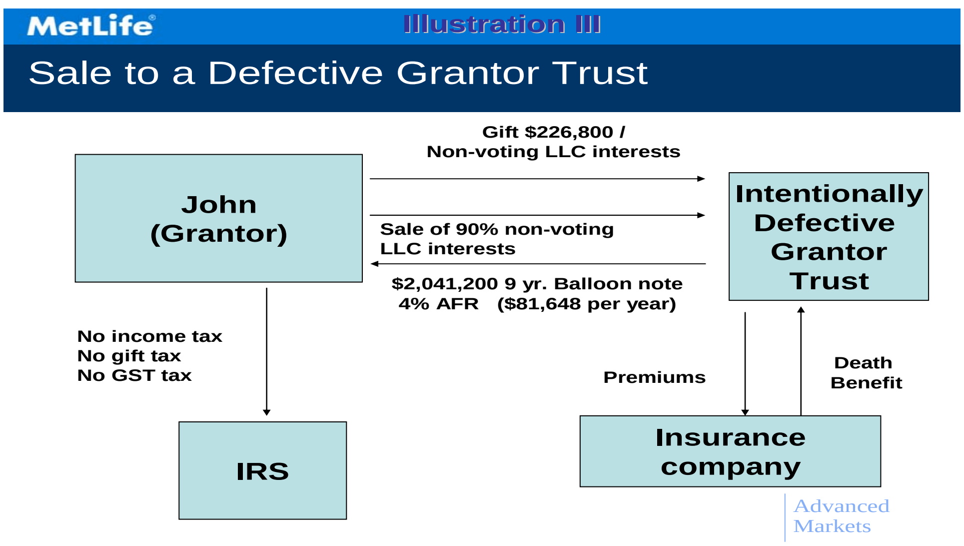
A sale to an intentionally defective grantor trust works well in a low interest rate environment if the goal is to freeze the business owner's estate. A sale to an IDGT should also be considered where the defective trust is designed to be a generation-skipping trust. If the arrangement is structured properly, the sale will not be a considered a transfer for either gift tax or generation-skipping transfer tax purposes. The children could be given authority as trustees to help manage the trust, including the business interest held by the trust. At the time of the children's death, the assets held by the generation-skipping trust are not included in their taxable estates and pass tax free to the next generation. The children could be given a testamentary limited power of appointment over their respective shares to change the terms of the trust, if they should decide to do so.

The following hypothetical illustrates how a sale to a defective grantor trust can freeze the value of the business interest and tax efficiently pass the value of the closely held business to the next generation.

> *John, age 64, holds a 90% interest in Cornell Development, LLC, a limited liability company recently appraised at $4 million. The business expects to realize significant growth over the next five to ten years. John is married to Mary. John and Mary have three adult children - Jack and Cheryl who work in the business and who each own 5% of the company, and Ted who is a professor at a nearby college. The business generates about $180,000 of income. John and Mary want to retire and keep the business in the family. They are concerned about estate taxes, transferring the business to Jack and Cheryl, providing equitably for Ted and assuring adequate funds for their retirement.*
>
> *John elects to reorganize the LLC into 10% voting and 90% non-voting interests. John creates an intentionally defective grantor trust and funds the trust (i.e., seed money) with a gift of 10% of his non-voting interests valued at $226,800 ($324,000 less a total discount of 30% for lack of control and lack of marketability). John then sells the balance of his non-voting interests to the*

intentionally defective grantor trust for $2,041,200 ($2,916,000 less a 30% discount for lack of control and lack of marketability).

The sale to a defective grantor trust provides a number of advantages to John and Mary. First, assuming an applicable interest rate of 4%, the sale provides them with an annual retirement income of $81,648. Second, by applying valuation discounts to both the value of the gifted shares and to the price of the sold shares, John and Mary are able to depress the value of their estates. Third, John's payment of the trust's income taxes is essentially a tax-free gift to his children. Fourth, the sale freezes the estate, as only the outstanding balance of the note is included in their estates. Finally, the sale to the trust not only avoids capital gain tax but assuming the valuation holds, it will also avoid gift and generation-skipping tax as well.



Using a Self-Canceling Installment Note (SCIN)

Another variation of the installment note is the self-canceling installment note or SCIN. One of the principal problems with an installment note is that its value is included in the seller's estate. The SCIN can be structured to be self-canceling at death and its value thereby excluded from the seller's taxable estate.[9] In order to avoid a taxable gift at creation of the note, the payment on the note must reflect the likelihood that the seller may die before the note is paid in full. The greater the likelihood (using actuarial tables), the greater the premium that must be paid. If the premium is too low, the IRS can assert that a gift was made at the time of the sale.

The SCIN is an excellent way to reduce estate taxes in those situations where the seller's actual life expectancy is shorter than the actuarial table (i.e., where the seller is in poor health). One significant disadvantage of the SCIN is that cancellation of the note at death may cause any remaining gain in the note to be immediately taxed.

[9] *Estate of Moss*, 74 TC 1239 (1980) acq. in result.

Private Annuity

A sale of the business interest can also be effected through use of a private annuity. A private annuity involves a purchase in which the buyer, in exchange for the business interest agrees to pay the seller payments over a designated period, typically the seller's life. The appeal of a private annuity is that the property conveyed is immediately removed from the seller's estate. The illiquid property is exchanged for an income stream, with the resulting taxes spread over the payment period. To make the value of the private annuity contract equal to the fair market value of the business interest being sold in exchange for the contract, the amount of the annuity payments must be set accordingly, taking into account the annuitant's age and current interest rate as provided under Section 7520 of the Code. The buyer takes over the management of the property and all appreciation is removed from the seller's estate.

Unfortunately, there are several drawbacks to the private annuity, which limit its usefulness. Unlike an installment sale, gain on the transfer of property in exchange for a private annuity cannot be deferred. As a result, private annuity transactions should be considered when the property to be sold has little or no built–in gain. A second disadvantage is that most private annuities are for the seller's lifetime and if the seller lives too long, the buyer not only made a bad investment, but the additional payments inflate the seller's estate. A third disadvantage is that the seller bears the total risk if the buyer defaults on the payments, as the annuity interest must be unsecured to avoid immediate taxation to the seller.

Private annuities work well in a low interest rate environment since a low interest rate will reduce the amount of the annuity payment. They also work well where the seller–annuitant has a life expectancy shorter than that prescribed in the Internal Revenue Service's life expectancy tables. If the seller-annuitant is terminally ill and has, for instance, a 50% chance of dying within one year, a private annuity cannot be valued using the Service's life expectancy tables. However, if there is at least a 50% probability that the seller-annuitant will live for at least one year, the use of the life expectancy tables is permitted.[10]

With a private annuity, there is a need for life insurance on the buyer's life, as the buyer is obligated to make annuity payments for the life of the seller. This obligation continues even if the buyer predeceases the seller. The buyer's spouse or his/her irrevocable trust could own this insurance.

Charitable Stock Bailout

When the business is a "C" corporation and has excess cash, the owner might consider the use of a Charitable Stock Bailout to pass the business to his or her heirs. A charitable stock bailout occurs when a shareholder contributes stock in a closely held

[10] Treas Reg. § § 1.7520 – 3(b)(3), 20.7520 – 3(b)(3) and 25.7520 – 3(b)(3)

corporation to a charitable entity, typically a charitable remainder trust (CRT) and that stock is later redeemed from the charitable entity by the corporation for cash. If a CRT is used, the CRT invests the cash and the owner receives a stream of income that is not tied to the business. There is no current capital gain or ordinary income reported on the sale and the owner receives a valuable charitable tax deduction as well.[11]

These charitable stock bailouts can have considerable tax advantages. With individual tax brackets often higher than corporate rates, the charitable deduction can mean more to the individual than to the corporation. A charitable stock bailout can also reduce concern about excess accumulated earnings inside a "C" corporation and serve as a method of reducing a shareholder's estate (by removing the value of the contributed stock).[12] If the corporation has family member minority shareholders, the contribution of stock can shift more of the future appreciation and more of the control to the second-generation family members. The following hypothetical shows how a charitable stock bailout could achieve the client's objective of passing control of the business to his son with little or no transfer costs.

> *Harry, age 68, owns 75% of ABC Corporation, a profitable "C" corporation which has substantial retained earnings. Harry is married to Sally, age 62. They have two sons. Jim who is President of the business and who owns 25% of the stock and Jules, who is not active in the business. Harry was recently offered $10 million for the business.*
>
> *Harry and Sally have the following objectives:*
>
> - *First and foremost, provide a substantial lifetime income for their joint and survivor lifetimes.*
> - *Also important to Harry is transferring control of the business to his son, Jim, with little or no transfer costs.*
> - *Harry and Sally are also charitably inclined and wish to provide a substantial benefit to their favorite charity, the American Red Cross.*
> - *Harry and Sally also feel it is important to treat their two sons equitably and want to make provisions for their other son, Jules.*
>
> *After numerous talks with their advisors, Harry and Sally decide to establish a charitable remainder unitrust. They elect to reserve a unitrust interest equal to the lesser of the income of the CRUT for the taxable year and 5% of the net fair market value of the assets of the CRUT. The CRUT contains a net income make-up provision, which specifies that to the extent the aggregate amount paid in the prior years was less than the 5%, the excess income in any year would be used to make up the deficiency.*

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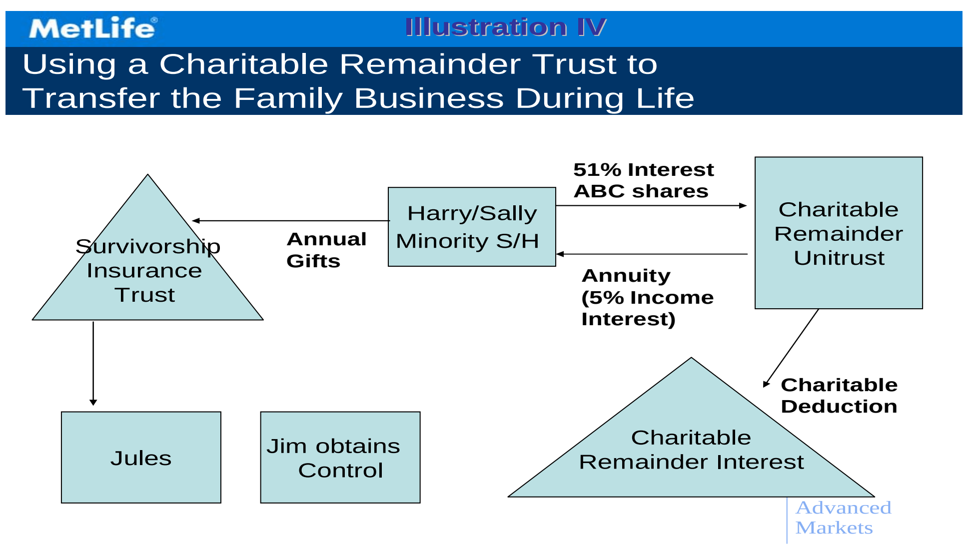
[11] The IRS takes the position that any prearranged or anticipated sale of the business interest prior to its transfer to the CRT will negate the tax effects of the donation and sale. That is, if there is a prior (i.e., prior to the CRT) arrangement or understanding that the CRT will sell the business interest, the IRS may recharacterize the transactions as first a sale of the business and then a contribution of the sale proceeds to the CRT.

[12] IRC § 532(a)

Harry contributes 51% of his ABC Corp. shares to the CRUT. The Section 7520 rate is assumed to be 4% and that the CRUT will ultimately be able to earn 7% from income and appreciation. One year after the contribution of the stock to the NIMCRUT, the Board of Directors of ABC Corporation elects to redeem 51% of its outstanding shares for its then fair market value. Assuming the business is still worth $10 million and a 51% interest is worth $5,100,000, ABC Corporation makes it redemption offer to both Jim and the CRUT and the CRUT accepts the offer. ABC Corporation uses its retained earnings and available bank lines of credit to pay for the stock.

As a result of implementing the charitable stock bailout, the CRUT receives $ $5,100,000 in cash and pays no tax on the redemption. Jim obtains control of the ABC Corporation and Harry and Sally pay no transfer costs. Harry and Sally receive income for their joint and survivor lifetimes. The first year the income is $255,000 and future payments will depend upon whether the trust property increases or decreases in value. Finally, Harry and Sally receive $1,737,000 of income tax deductions for their charitable contribution.

One downside inherent in this technique is that at the death of the surviving spouse, the remaining funds in the CRT pass to the charity and Jules is disinherited. The solution is to purchase a survivorship life insurance policy and hold it in trust for Jules' benefit.



(4) Sale at Death - Buy-Sell Agreement

A properly funded buy-sell agreement gives the children who are active in the business the right and the wherewithal to purchase the owner's interest in the business at the owner's death, disability and/or retirement. A buy-sell agreement can appear to be more equitable to the children who are not active in the business as the active child is not being given the business. The child who is active in the business is purchasing the business with the life insurance proceeds and the profits of the business, both of which were made possible through the child's efforts.

In addition, the buy-sell agreement may be attractive where the surviving spouse lacks sufficient non-business assets to maintain his or her support. A buy-sell agreement funded with life insurance will provide an infusion of cash to a surviving spouse who otherwise lacks sufficient non-business assets to maintain his or her lifestyle. In addition, a properly funded buy-sell agreement can provide the necessary funds at the spouse's subsequent death to treat inactive children in a fair and equitable manner.

A buy-sell agreement can also be used when the surviving spouse lacks sufficient non-business assets and new insurance on the business owner's life is not available due to age or underwriting considerations. In this situation, existing life insurance can be used to fund a portion of the purchase price with the remaining amount paid in installments over a sufficiently long period of years to avoid putting financial pressure on the business. Care must be taken in transferring any life insurance policy so as to not run afoul of the "transfer for value" rule.[13]

Structuring the Buy-Sell Agreement

The one-way cross purchase agreement will be the agreement of choice for most family businesses. Under a one-way cross-purchase agreement, each child who is active in the business purchases an insurance policy on the life of the parent/owner. The child is the owner and beneficiary of the policy and at the death of the parent, the child will receive the insurance proceeds income tax free and use them to buy out the deceased parent's business interest. In this way, the spouse, who will generally be the primary beneficiary of the estate, will indirectly receive the benefits of the life insurance. If the death proceeds are not adequate to cover the purchase price, any shortfall can be paid using an installment note over a sufficiently long period so as not to place an undue financial burden on the active children.

The amount of the life insurance can be less than the full value of the business if the owner begins a program of gifting stock to the children who are active in the business. In this situation any new premium dollars should be allocated to survivorship insurance to provide the additional assets needed to treat the inactive children equitably.

If there is concern about the children carrying out the buy-sell agreement at the owner's death, or if there is a desire to limit the number of policies purchased, the parties could enter into a trusteed arrangement. The trustee (or escrow agent) would be the legal owner and beneficiary of the life insurance policy (or policies) and could also hold the shares of stock in the trustee's name. The children would continue to be the beneficial owner and beneficiary of their fractional share of the insurance policy on the parent's life. At the time of the parent's death, the trustee would collect the insurance proceeds,

[13] IRC § 101(a)(2)

pay the monies to the parent's estate and in exchange transfer the parent's stock to the children.

A cross purchase buy-sell agreement can be contrasted with a redemption buy-sell agreement where the business itself purchases the owner's interest in the business at a triggering event. While the redemption agreement is the easiest to understand and to administer, it presents a number of problems, especially for family-owned businesses. The cross purchase agreement largely avoids these issues.

First, the cross purchase agreement avoids the adverse tax treatment of a redemption agreement. The redemption proceeds payable by a family-owned "C" corporation (or by a converted "S" corporation with "C" corporation earnings and profits) are generally treated as a dividend and not a sale and exchange.[14] This will result in the parent's estate, whose interest is being redeemed, having to treat the proceeds as dividend income to the extent of the corporation's earnings and profits. There is no tax-free recovery of basis as would be the case if the redemption were treated as a sale and exchange. Because of the constructive ownership (attribution) rules that impute stock owned by family members to the redeeming shareholder's estate, it would not be not possible for a deceased shareholder's estate to avoid this adverse tax treatment.[15] The solution is to structure the arrangement as a cross purchase agreement.

Second, the cross purchase agreement for a "C" corporation also avoids the corporate alternative minimum tax (AMT). The death proceeds used to fund a redemption agreement can be subject to the corporate AMT. This tax, which applies to certain "C" corporations with average gross receipts of $7,500,000 or more for the previous three years, is a flat 20% tax of the regular taxable income plus certain tax preferences.[16] One such preference is the excess of the death benefit over booked cash values. Under the worst-case scenario, 75% of this excess will become subject to the 20% AMT, resulting in a 15% flat rate. When this tax applies, it increases the tax cost of using a funded redemption agreement in a "C" corporation. The corporate AMT does not apply to an "S" corporation.

Third, the cross purchase agreement gives the children a tax basis in the stock equal to the purchase price of the stock acquired from the deceased parent's estate. Therefore, there will be a smaller capital gain upon a subsequent sale of the "C" corporate stock. In addition, since the deceased parent's estate receives a step up in basis on the shares includible in the estate, the sale of these shares to the children will not generate any taxable gain. While surviving shareholders in a "C" corporation receive no increase in basis, the surviving shareholders in an "S" corporation will enjoy at least a partial step-up in basis to the extent they are allocated a portion of the life insurance proceeds

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[14] IRC § § 301 (a) and 301 (c); Rev. Rul. 55- 515, 1955-2 CB 222

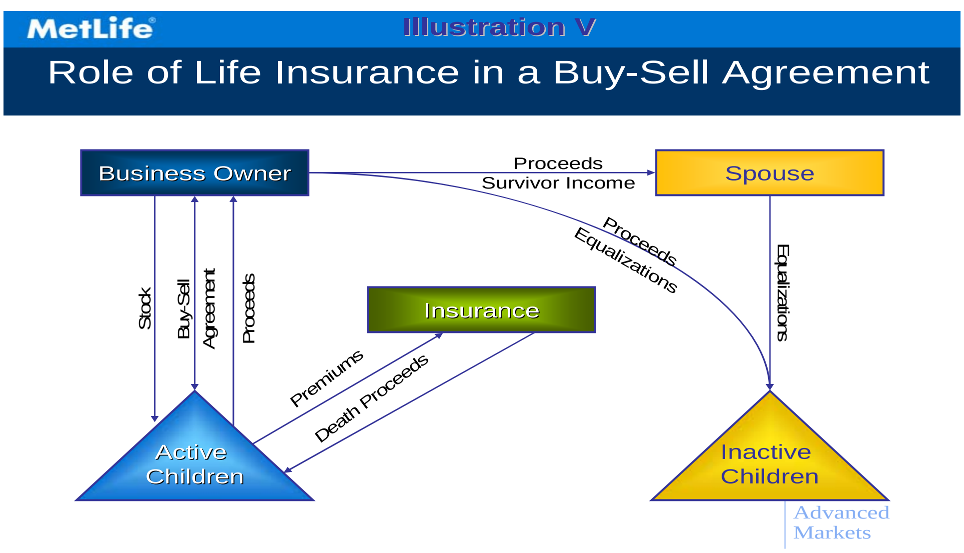
[15] IRC § 318 (a)

[16] IRC § § 55-59

payable to the “S” corporation. Furthermore, if the agreement so provides, it is possible to allocate 100% of the death proceeds to the surviving shareholders of a cash basis (but not an accrual basis) “S” corporation.[17] In a partnership and in a limited liability company, the partnership or operating agreement can provide for a special allocation of the entire death proceeds to the accounts of the surviving partners or members.

A fourth benefit of the cross purchase agreement is that the cash values and death proceeds are not exposed to the claims of the business creditors. They may, however, be vulnerable to the shareholder’s creditors. This advantage applies to all types of business entities, not just “C” corporations.

Lastly, where the business purchases life insurance on its owners to fund the redemption agreement, the pure death benefit (i.e., the portion of the death benefit in excess of the cash value), should typically not be included when determining the value of the business interest for both buy-sell and estate tax purposes. In order to exclude the pure death benefit, the price contained in the redemption agreement must (1) specifically exclude this portion of the death benefit, and (2) the resulting buy-sell price must be binding for estate tax purposes. As discussed previously, it is clearly a problem for a family owned business to fix the value for estate tax purposes. Therefore, in a family owned business the death proceeds received by the business will generally increase the value of the deceased shareholder’s business interest for estate tax purposes. On the other hand, since the other business owners hold title to the life insurance policies under a cross purchase agreement the death proceeds do not increase the value of the deceased shareholder’s business interest



17 IRC § 1377 (a)(2)

Identifying the Active Children

If all of the children have not had an opportunity to come into the business and it is not clear who will ultimately take control, then consideration should be given to having an irrevocable trust hold the life insurance. Upon the owner's death, the trustee could use the death proceeds to purchase the business interest from the owner's estate. The business interest can be held in trust for all of the children's benefit until all of the children have had an opportunity to come into the business. At that time, the trustee can distribute the business interest to the children who are active in the business free of both gift and estate tax.

Key Persons

Incentives need to be put in place to insure that the key people will stay with the business upon the owner's death and during the transitional period, which follows. Their loyalty is to the business owner and not necessarily to the younger generation who will need to rely on them. Unfortunately, the children may need them more than the owner. Whether these key executives stay or leave for a competitor may depend upon the incentives the business owner puts in place today. A nonqualified retirement plan whose terms include a graded vesting schedule and a substantial deferred benefit can be an effective tool in keeping the senior management team together after the owner's death.[18] The plan could be tied to individual performance or alternatively to a formula that mirrors the growth of the business such as a phantom stock plan.

Funding

The buy-sell agreement, however, will only be as good as the financial arrangements that have been made to support it. The agreement may guarantee the right to buy and provide a binding contract to sell and yet, when the time comes, if the active children do not have the funds with which to make the purchase, the plan may collapse. The life insurance death benefit provides a definite sum of money at an indefinite time to carry out the terms of that agreement. On the other hand, a buy-sell agreement, without adequate funding, may place the parties in a worse situation than having no agreement, for the buy-sell agreement creates legal obligations with no funds to meet those obligations.

To assure that there is sufficient liquidity for the active children to purchase the business, it is recommended that the active children be the owners and beneficiaries of a life insurance policy on the parent. At the parent's death, the children receive the death proceeds and use those proceeds as a substantial down payment for the purchase of the business. The balance of the purchase price can be paid with an installment note, utilizing the future cash flow of the business to repay the note. In this way, the death proceeds are not included in the estates of either the owner or his or her spouse, as the proceeds are simply exchanged for the illiquid business.

[18] See IRC § 409A

Valuation

One of the most important provisions found in a buy-sell agreement is the one that establishes the price to be paid for the business. In order for the IRS to accept the price established by the family members, the agreement must meet six tests:[19]

Price - The price must be fixed and determinable by the agreement.

Obligation to Sell - The estate must be obligated to sell at the price contained in the agreement.

Lifetime Obligation To Sell - The agreement must restrict the sale of a business interest during an owner's lifetime unless the business or other owners are given a right of first refusal to purchase the interest at the price contained in the agreement.

Bona Fide Agreement - The agreement is part of a bona fide business arrangement. This is a rather easy test to satisfy as the need to maintain continuity of management constitutes a bona fide business purpose.

Not a Device - The agreement must not be a device to transfer the business interest to the owner's heirs for less than full or adequate consideration in money.[20] This "device" test is a question of fact to be determined on a case-by-case basis. The Tenth Circuit has ruled that a buy-sell agreement among family members did not control for estate tax valuation purposes because the buy-sell agreement was a substitute for a testamentary disposition.[21] The Tenth Circuit rejected the taxpayer's argument that the tax book value formula and the other restrictive terms of the buy-sell agreement controlled the value of the transferred interests for estate and gift tax purposes. The Court concluded that the buy-sell agreement was a testamentary substitute because (1) the taxpayer did not obtain independent appraisal to determine whether the formula in the buy-sell agreement constituted fair market value, (2) the formula contained in the buy-sell agreement excluded intangible assets, (3) the buy-sell agreement failed to contain a mechanism to re-determine the price terms, and (4) there was no negotiation between the taxpayer and his children as to the terms of the buy-sell agreement.

Comparable - Where an agreement is between family members, it will be necessary to show that the terms of the agreement are comparable to similar arrangements entered into in an arm's length transaction. The parties must be prepared to show that any right or restriction in the agreement could have been obtained in a fair bargain between unrelated parties in the same type of

[19] IRC § 2703
[20] Treas. Reg. 20.2031 - 2(h)
[21] *Estate of True*, 94 AFTR 2nd 2004-7039 (CA –10,2004)

> transaction. Unfortunately, it is difficult to find actual comparable arrangements. If no actual comparables are available, the test for meeting the comparability requirement is whether "the right or restriction is one that could have been obtained in a fair bargain among unrelated parties in the same business, dealing with each other at arm's length."[22]

In short, current law makes it extremely difficult to use a buy-sell agreement to fix the value of a family-owned business for estate tax purposes. It is generally prudent to provide that the purchase price under the buy-sell agreement will be the fair market value at the time of death determined by independent appraisal or alternatively, by a formula which approximates the fair market value at such time.

Estate Can Redeem Shares to Pay Estate Tax Using a 303 Stock Redemption

Section 303 of the Code permits a corporation to redeem a portion of a decedent's stock without the payments being considered a dividend. The redemption is treated as a sale and exchange. Since the stock held by the decedent receives a step up in its basis to the fair market value at the date of death (or the alternate valuation date), a subsequent redemption at that fair market value price avoids any capital gain.

The business owner's estate must meet several requirements to obtain the benefits of Section 303:

The value of the closely held stock in the decedent's estate must exceed 35% of his or her adjusted gross estate.[23] This is the gross estate minus taxes, losses, debts, and funeral and administration expenses. While transfers of the business interest during life may reduce the size of the estate, such transfers may also jeopardize the availability of Section 303.

The redemption amount cannot exceed in value the total of federal and state death taxes and funeral and administration expenses.[24] There is, however, no requirement that the proceeds actually be used to pay those estate settlement expenses.

The estate of the person whose shares are being redeemed must bear the burden of the federal estate taxes, the state death taxes and the administration expenses in an amount at least equal to the amount of the redemption.[25]

Generally, the redemption has to be made after the client's death but within three years and 90 days after the filing of the federal estate tax return.[26]

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[22] Treas. Regs. 25.2703 –1 (b)(4)(i) and 25.2703 – 1 (b)(4)(ii)

[23] IRC § 303 (b)(2)(A)

[24] IRC §§ 303(a), 303(d)

[25] IRC §§ 303(b)(1), 303(b)(4)

The usefulness of Section 303 is limited in the typical family business situation where the business owner is married and is reluctant to pay any federal estate taxes at the first death. In this case, if the business owner predeceases his or her spouse, the owner's estate plan will typically utilize his applicable exclusion amount and/or a buy-sell agreement to transfer as much of the business interest as possible to the children who are active in the business. The owner will pass the balance of his estate to his spouse either outright or in a QTIP trust in order to qualify this bequest for the marital deduction and defer any tax until the second death.

However, in the appropriate situation (e.g., unmarried owner with substantial interest in a closely held business, or in the event of a second marriage), a Section 303 redemption may be an excellent tool to pay various estate settlement costs. To avoid having the insurance proceeds which are used to fund the redemption inflate the value of the business itself, consider having the insurance held and made payable to an irrevocable life insurance trust and provide express authorization for the trustee to lend monies to the corporation to effect the redemption.

IV. Conclusion

A business succession plan is a crucial part of any business owner's estate plan. Failure to properly arrange an orderly transition to the next generation can generate unnecessary conflict, result in needless estate transfer costs and even jeopardize the very survival of the business. These consequences are even more likely in a family situation where emotions and unresolved family issues create even more complexity.

Assuming the business is to remain in the family, the first step is to address the three primary objectives of (1) creating financial independence for the owner and his spouse, (2) passing control to the active children and (3) equitably providing for the inactive children. If the transition is to be successful, these issues must be addressed early in the process. Secondly, as discussed, there are a number of ways to shift control to the next generation. Determining which technique or techniques will best meet the client's objectives will depend upon the facts of the case and the personalities of the family members.

[26] IRC § 303(b)(3)

APPENDIX I

The Type of Business and Succession Planning

The selection of the type of business entity will impact one's ability to properly integrate the client's estate plan with his or her business succession plan. While a lengthy description of each type of business entity is beyond the scope of this article, the following summarizes the benefits as well as the limitations of each type of business as it applies to lifetime transfers.

C Corporation

The corporation is taxed as a separate entity and offers the owner(s) a level of protection from the debts and liabilities of the business. Unless the shareholders agree otherwise, a shareholder is generally free to sell, gift or bequeath his or her stock without any restrictions. This type of entity allows the creation of multiple classes of stock with different voting rights. This feature is very useful in establishing valuation discounts on gifts of company shares to the active children.

S Corporation

This type of corporation allows the owner(s) to be taxed essentially as a partnership for federal income tax purposes. In effect, the election removes the double taxation that an owner faces in a "C" corporation. In order to maintain the "S" corporation status for tax purposes, one needs to limit the type and number of shareholders and issue only one class of stock, although voting and nonvoting common stock can be issued.

Limited Liability Company (LLC)

This type of entity provides both the limited liability of a "C" corporation and the pass-through taxation of a partnership. The LLC is attractive because it has few ownership restrictions and permits several classes of membership interests. For business transfer purposes, the LLC permits the owner to serve as manager and maintain effective control of the business while still transferring much of the value to the next generation. Membership interests in the LLC can also be easily transferred.

General Partnership

A general partnership is made up of two or more co-owners that are engaged in a business for profit. The partners generally share profits and liabilities based on the percentage of ownership and can be held personally liable for dealings with third parties. Unless otherwise elected, a partnership is dissolved at the withdrawal, disability or death of one partner. In addition, no outside individuals can become a member of the partnership without the consent of all partners. The options a partner can use to gift or bequest ownership shares to a family member are quite limited.

Limited Partnership

This type of business entity consists of one or more general and limited partners. The general partner (may be an individual, corporation or LLC) manages the business while the limited partners provide the bulk of the capital. Liability primarily rests with the general partner, as the limited partner's liability is limited to his or her investment in the partnership. The most common type is called the family limited partnership (FLP). In most cases, it is formed with the express intent to shift ownership assets to the next generation of family members. In a typical FLP, the parents hold the general partnership interests and gift limited partnership interests to their children.

Sole Proprietorship

This form of business entity is a pass-through entity for tax purposes. It requires no formalities to create. Since there is no stock, it is difficult to transfer any ownership interest during the sole proprietor’s lifetime. In addition, assets in a sole proprietorship may be subject to probate, federal estate taxes and inheritance taxes in the sole proprietor’s state of residence. This type of business provides very limited opportunity for lifetime transfer planning and no opportunity to limit liability.

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