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BUSINESS SUCCESSION:

ABDICATE? AFFILIATE? ALIENATE? BIFURCATE? SYNDICATE? LIQUIDATE? VACILLATE? DON'T WAIT. COGITATE AND PARTICIPATE?

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I. <u>The Challenges Inherent in Business Succession Planning</u>

A. There is not a special category of estate planning strategies designed solely for use when an owner is planning for the future transfer of her or his business interests or selling. Rather, the usual array of planning strategies and transfer tax techniques are available to owners. Indeed, some of these techniques may be especially effective with such interests.

1. Direct gifts using the annual exclusion and the lifetime gift exemption.

2. Grantor Retained Annuity Trusts.

3. Sales to irrevocable grantor trusts in exchange for a note.

4. Use of multiple classes of equity to freeze or limit the growth of certain equity owners.

5. Transfers using limited partnerships or LLCs, to facilitate transfers of value while maintaining consolidated management, and to better take advantage of valuation discounts.

6. Use of a charitable remainder trust to avoid immediate capital gain upon a sale.

B. With a private business, the selection and implementation of those techniques will be influenced by a variety of other factors.

1. The nature of the business and its capital structure.

2. The ability of the business to generate cash flow, and business needs for the cash flow.

3. The primary owner's future plans for the business and succession to leadership of the business.

C. The key to any successful lifetime planning is to match the client's situation and assets with the appropriate technique. In the closely-held business context that means matching the technique with these unique factors.

D. There will be situations where the planning is occurring in anticipation of a sale or other anticipated exit strategy. More commonly, however, the client will not know whether he or she eventually will sell the business, or his or her interest in it. The best the client can tell you is that he or she might.

1. For example, the client's children might be younger, and not yet at an age where the client can determine whether they will be involved in the business. If they become involved, the client may want to preserve the business; if not she may wish to sell it.

2. Or, there may be employees that the client would like to succeed to the business. But, if it turns out they do not share that interest, or cannot afford it, then the client would sell.

3. Many business owners openly say they want to continue to operate the business but that they might change their view "if the right offer came along."

4. There also are a variety of ways in which succession to the business interests can take place.

   a. Transfers during life or at death to family members.

   b. Redemption of equity interests.

   c. Direct sale to a third party of equity interests.

   d. Merger into the purchasing entity or acquisition by it in exchange for stock.

   e. Sale of assets.

   f. Sale of minority equity interests to a new investor.

   g. Refinancing, with issuance of special categories of debt or convertible debt.

   h. Sale to an Employee Stock Ownership Plan.

   i. Public offering.

E. Planning in these situations means not committing to any one strategy that is focused on a specific outcome (i.e. succession to the business by family members, or sale in a tax-advantaged format). The strategies have to work in different scenarios. Fortunately, most strategies do provide benefits regardless of the ultimate goal or outcome. It becomes a matter of careful counseling of the client.

EXAMPLE. Janet owns 20% of her family's business. An opportunity presents itself to transfer a significant portion, possibly all, of her stock to trusts for her children at a relatively low transfer tax cost. Janet's initial reaction is to transfer almost all of her stock, to avoid taxation in her estate. Her attorney asks her if she would be comfortable with that strategy if the company sold 10 years from now and Janet's stock was worth $50 million. Would Janet want her children to have that level of wealth? Would Janet want some of that wealth for herself?

EXAMPLE: Over a period of many years, business owner makes gifts of voting stock in the family business to separate trusts for his three children. Many years later, one child emerges as the clear choice to run the business. Based on the ownership at that time, his siblings who are far less involved in the business together could outvote the child who will lead the business. In retrospect, a one pot trust would have been preferable with provisions for giving one child control.

F. If and when a sale becomes a probability or a certainty, the transfer tax techniques in place or contemplated have to be adaptable to the sale and its form. Again, most planning strategies are flexible enough to avoid interfering with a sale. But an extremely complex, over-engineered structure could make it more difficult someday to find buyers.

G. The discussion in these materials will repeatedly focus on certain key elements for any successful succession plan.

1. Flexibility

2. Bifurcation

   a. Separate control from equity

   b. Separate the equity, to create non-controlling interests

3. Diversification – usually multiple techniques must be used.

4. Transfer tax savings, of course, but

5. Non-tax factors related to succession cannot be ignored.

II. Control Issues

A. Many business owners want to make gifts for tax planning purposes but adamantly refuse to give up voting rights or permit certain family members to participate in the business other than as a silent investor. Other owners may want to address the differing needs of family members while giving away interests in the business. For example, some owners may want family members to share equally in the business from an investment standpoint, but not from a participation standpoint.

B. A traditional way of handling these issues is through the use of trusts.

   1. An individual can transfer stock in the business to a trust for certain family members and name a trusted advisor, business colleague, or child in the business as trustee. The family members will receive income from the stock and benefit from its appreciation, but the trustee will vote the stock.

   2. The donor of closely held stock should not act as trustee because his or her retained right to vote the stock will bring it back into the estate under Section 2036(b). Often the donor names his or her spouse as trustee.

   3. A family member who does not participate in the business can be given an income interest for life, with the businesses interest eventually passing to another family member who is actively involved in the business.

C. A business owner also can change the capital structure of the business to address control and other non-tax goals. One of the easiest structural changes available to a business owner is to create a class of nonvoting stock. For a partnership, limited partner interests are used. In an LLC, the primary owner can create a class of non-voting member interests.

   1. An owner who will not relinquish absolute control can use nonvoting stock to give away equity in the company without reducing his or her voting control.

   2. If the owner wants to leave the business equally to his or her children, but fewer than all the children participate in the business, the owner can give voting stock to the children who are active in the business and nonvoting stock to the children who are not.

   3. From a tax planning standpoint, nonvoting stock often is issued to isolate the voting stock in a small percentage of the value of the company. This makes it easier to eventually pass control to the next generation.

      EXAMPLE: Oliver Owner owns 100% of a business worth $40,000,000. He wants to pass control to a GST trust that will be controlled initially by his son as trustee. His son can designate successor trustees, and, if he fails to do so, a trio of independent trustees is named. Oliver recapitalizes the business and issues nineteen shares of nonvoting stock for each outstanding share of voting stock. The voting stock is now worth $2,000,000. Oliver transfers the voting stock to a GST trust, and allocates his GST exemption to the trust to completely shelter it from future transfer taxes for several generations.

4. By making gifts of nonvoting stock, an individual can eliminate Section 2036(b) issues. The individual does still need to be careful about retaining decision-making rights in a trust to which non-voting stock may be transferred. Even if the stock is non-voting, its holders may have rights under state law to vote in certain extraordinary transactions.

   a. In Revenue Ruling 67-54, 1967-1 C.B. 269 the IRS asserted that the grantor of a trust retained control over the income from non-voting stock transferred to the trust by virtue of retaining the voting stock.

   b. The IRS revoked Revenue Ruling 67-54 in Revenue Ruling 81-15, 1981-15, 1981-1 C.B. 457. The IRS suggested that the reasoning of <u>United States v. Byrum</u>, 408 U.S. 125 (1972), compelled this result. Based on <u>Byrum</u>, the power of a controlling shareholder or directors to regulate the flow of dividends is constrained by their fiduciary duties.

5. Nonvoting stock can be used in S corporations. An S corporation can have only one class of stock, but nonvoting stock that is identical in all respects other than voting rights to voting stock is not considered a second class of stock under the S corporation rules.

III. <u>Aggregation and Disaggregation of Business Interests and its Impact on Valuation.</u>

A. Many clients fear having their business valued. It is as if a written business appraisal releases a great secret. In fact, the appraisal is an extremely valuable tool. It lets the client, and his or her professional advisers, know what value they need to work with and how big the estate tax problem is.

   1. The appraiser also can help forecast likely increases in value if the business continues trending in line with prior performance.

   2. Most important, the valuation, in particular the discounted value of minority interests, gives everyone a reliable number to use for transfer tax planning.

B. The value of business interests for transfer tax purposes is influenced in a major way by the size of the interest relative to the entire business.

   1. It is well-accepted that minority interests in a business will be worth less than their proportionate share of the whole business value, due to lack of ability to control business operations and distributions.

   2. By contrast, a controlling interest may be valued at a premium.

   3. A large block of stock in a corporation that is traded in a thin market will be entitled to a discount because the sale of the stock at one time would overwhelm the market and depress the price.

   4. Lifetime estate planning often is aimed at fractionalizing business interests to take advantage of discounts.

5. Post-death administration can involve the same type of planning, as business interests are allocated among marital and non-marital trusts or among trusts for descendants to try to put the successors to the interests in more advantageous valuation situation.

6. This is a challenging area to navigate. For some transfers, such as marital deduction transfers at the first death, higher values (to achieve a higher tax basis) are desirable; while lower values are the goal in taxable transfers.

C. Non-Aggregation of Differently Owned Interests

1. For many years, the IRS has tried to find ways to aggregate interests in a privately owned business entity, with the goal of reducing or eliminating valuation discounts that otherwise would be available.

a. The Service frequently turns to the theory of "family attribution" – that family members owning equity interests in an entity will cooperate and not exercise rights to each other's detriment.

b. The IRS has generally been unable to obtain validation of this theory in the courts, but it has found some success through legislation; for example elements of family attribution are found in Sections 2701 to 2704, under Chapter 14 of the Code.

c. In Revenue Ruling 93-12, 1993-1 C.B. 202, the IRS conceded judicial defeat and held that intra-family transfers of closely held stock are valued for estate and gift tax purposes without consideration of the fact that control of the corporation rests in the family.

2. The courts have taken the non-attribution rule one step further, by requiring that business interests included in the estate for tax purposes but owned separately for property law purposes not be aggregated for valuation purposes.

3. For many years, the IRS had taken the position that the starting point for determining whether a closely-held asset should be valued on a discounted basis is calculation of how much of the asset is included in the decedent's gross estate. The division of ownership of the asset was considered irrelevant. Thus, if an asset is owned 40% by the decedent, 30% by a trust included in the decedent's estate under Section 2036, and 30% by a marital trust included in the decedent's estate under Section 2044, the IRS would treat the decedent as owning 100% of the asset. Accordingly, minority interest or fractional share discounts would not be permitted. See, e.g. Letter Rulings 9608001 (February 23, 1996); 9550002 (December 15, 1995).

4. In 1996, the Fifth Circuit Court of Appeals rejected this position in Estate of Bonner v. United States, 84 F.3d 196 (5th Cir. 1996). The court held that a fractional interest discount was applicable in valuing the decedent's interests in real property for federal estate tax purposes, even though the ownership was divided between the decedent and a QTIP trust that was also included in his estate. Two Tax Court cases followed the result in Estate of Bonner.

5. In Estate of Mellinger v. Comm'r, 112 T.C. 4 (1999) the decedent was the widow of the founder of Frederick's of Hollywood, Inc. At her death, she held 27.8% of the stock in the company in a revocable trust. Another 27.8% was held in a QTIP created at Frederick Mellinger's death.

a. The estate and the IRS agreed that the blocks were less marketable, and subject to a larger discount, if valued separately rather than as a combined majority holding. The estate valued the stock as two separate, minority blocks at $4.79 per share. In its Notice of Deficiency, the IRS valued the stock at $8.46 per share, and at trial it argued for a value of $6.94 per share.

b. The court found that there was nothing in Section 2044 that required QTIP property to be treated as owned by the decedent for valuation purposes. It concluded that Section 2044 only required that a QTIP trust be taxed as part of the decedent's estate.

c. The decedent in this case did not have actual control over the QTIP trust or a power of disposition over the shares in the trust. The court held that each block of stock should be treated as a separate minority interest for valuation purposes. The Court ultimately applied a 25% discount and valued the stock at $5.2301 per share.

6. The court reached the same result in Estate of Nowell v. Comm'r, T.C. Memo 1999-15, which involved the valuation of interests in two limited partnerships.

7. These cases left open the question of what level of control over property included in a decedent's estate should cause the decedent to be treated as controlling it. In neither Mellinger nor Bonner did the decedent have any power of appointment over the QTIP trust. In Nowell, the decedent was a co-trustee of the QTIP trust with her grandson, and apparently also did have a limited power of appointment over the trust. However, this is not mentioned in the opinion and it is not clear whether the IRS raised the issue.

8. The IRS addressed this question in Field Service Advisory 200119013 (May 11, 2001). The Service concluded that a 50 percent interest in a corporation owned directly by the decedent and a 44 percent interest held in a general power of appointment marital trust should be aggregated for valuation purposes. The IRS relied in part on case law indicating that a general power of appointment over property has been treated as the equivalent of outright ownership. The Field Service Advisory stated that marital trust property subject to a general power of appointment is fundamentally different from a QTIP trust.

9. In Estate of Fontana v. Comm'r, 118 T.C. 318 (2002), the Tax Court followed the IRS's Field Service Advisory and determined that property owned outright and property in a general power of appointment marital trust should be aggregated for valuation purposes.

10. The more difficult question is whether a power of appointment that is broad, but is not a general power of appointment (for example, a power of appointment to any person or organization other than the decedent, his or her estate or the creditors of either), would constitute sufficient control to cause aggregation. In the Field Service Advisory, the IRS appears to concede that a limited power of appointment, even a broad one, is not the equivalent of outright ownership. The IRS acknowledges in its Field Service Advisory that the decedent in Nowell possessed a testamentary limited power of appointment. It then states:

> We recognize that in some situations, a limited power of appointment may afford the holder broad powers of disposition. However, the power holder would not, in any event, be authorized to appoint the property to his or her estate (or his or her creditors) as is the situation presented with a general power. . . . Given the nature of a limited power, and the fact that a limited power is not recognized for estate and gift tax purposes as affording the power holder sufficient control to generate any transfer tax consequences when possessed or exercised, the court in Estate of Nowell was justified in treating a QTIP trust

subject to a limited power in the same manner as a QTIP trust where the remainder beneficiaries are designated by the first spouse to die.

This is a significant concession by the Service. However, to avoid aggregation, QTIP marital trusts and not life estate/power of appointment marital trusts will have to be used.

IV. Lifetime and Post-Mortem Planning to Alter Values

A. Lifetime Planning to Take Advantage of Discounts.

1. The previously discussed valuation principles create a number of planning opportunities for the owner of closely held assets, and a number of opportunities for mistakes.

2. As previously discussed, lifetime gifts of small interests in the asset should permit the donor to use minority interest discounts. These discounts may not be available if the donor dies with the same property and is the majority owner.

EXAMPLE. F owns all 1,000 shares of the outstanding common stock of a closely held corporation. He recently had a formal appraisal of the company completed that valued the entire company at $4 million, or $4,000 per share. F, with the consent of his spouse, could make annual exclusion gifts to each of his 3 children and 3 grandchildren of 7 shares of stock if he uses a value of $4,000 per share (a total of $28,000 to each child and grandchild). Because he is transferring minority interests, he applies a 25 percent discount to the stock and values it at $3,000 per share. This permits him to transfer 9 shares to each of his children and grandchildren (9 x $3,000 = $27,000), or a total of 54 shares, instead of only 42. If F dies owning all 1,000 shares, he will not receive a minority discount for any of the stock.

3. Equally valuable are transfers that reduce the control of a majority shareholder and thereby reduce or eliminate any control premium that would be applicable to the interest at the majority shareholder's death. See Whittemore v. Fitzpatrick, 127 F. Supp. 710 (D.C. Conn. 1954). But see Estate of Murphy v. Comm'r., 60 T.C.M. (CCH) 645 (1990) (minority discount denied where decedent made gift 18 days before death in order to reduce her interest below 50 percent).

EXAMPLE. D owns 640 shares in a closely held corporation. D's brother owns the remaining 360 shares. The corporation has a value of $10 million or $10,000 per share. D transfers 50 shares to each of his three children (a total of 150 shares), and values the transferred shares at a 20 percent discount because they are minority interests so that the total value of the gifts is $1,200,000 instead of $1,500,000. In addition, because D has retained only 490 of the 1,000 shares after the gifts, he no longer possesses a majority interest and may have eliminated application of a control premium to his stock for estate tax purposes.

a. The danger in such a transfer is that D has given up actual control. D's brother and D's three children as a block could outvote D and take control of the corporation.

b. In many situations, however, the parent who is contemplating gifts of this type can count on cooperation from family members. Alternatively, the parent can put the stock in trust for the children with a reliable third party as trustee.

c. It may not be necessary for a controlling stockholder to reduce his interest below 50 percent to affect the control premium. For example, in some states, a two-thirds vote of the shareholders is required for liquidation. By reducing his interest below two-thirds, a controlling shareholder can eliminate this aspect of control and possibly reduce the amount of the premium that the IRS would attempt to apply to his stock.

4. This type of lifetime planning is important for any taxpayer who will have a taxable estate. If the taxpayer is married, and his or her estate will be non-taxable, it may make sense not to take all the steps that could be taken, in order to achieve a greater basis step-up. Then, after the taxpayer's death, the spouse can complete the planning.

   EXAMPLE. In the example above, D who owns 640 shares in a closely held corporation, is dying of cancer. He is married and his wife is in good health. D plans to transfer 150 shares of stock to a trust for his three children in order to reduce his ownership interest below 50%. His attorney advises him to transfer only 130 shares, to reduce his interest to 51%. His attorney also advises that D amend his estate plan to give D's wife a limited withdrawal right over marital trust assets. D dies and his stock is valued as a controlling interest, with a basis step up to its value as such. His 510 shares pass to the marital trust. D's wife exercises her withdrawal right to withdraw 20 shares from the trust. D's wife then gifts those shares to the trust for their children. She can make additional withdrawals and gifts over time. At her death, the marital trust has a minority interest and it is valued as such in her taxable estate.

5. A client may not be willing to transfer the stock in his closely held corporation because it will reduce his percentage vote in the company. This is often an issue in a family business owned by siblings or a business with some non-family shareholders. It may be important from a business perspective that the client not reduce his voting interest. The same issue sometimes arises in a wholly owned corporation; the client may be unwilling to let anyone else become a voting shareholder.

   a. It is these situations that call for the creation of a class of nonvoting stock.

   b. The client can use the nonvoting stock for gifts without diluting his voting interest. The gifts of nonvoting stock should be subject to valuation discounts just as minority voting interests would be.

6. The non-aggregation rules coming out of <u>Estate of Bonner</u> can provide very interesting opportunities for dividing control for tax purposes in the right circumstances.

   EXAMPLE. Velma holds voting control in a family business started by her and her husband, Allen. Velma and Allen are not ready to transfer voting stock to their children yet. Allen’s health is beginning to fail, and it appears likely he will pass away first. Velma transfers some of her voting stock to Allen so that now he owns 30% of the voting stock and she owns 45%. At Allen’s death, 20% of the voting stock goes to the credit shelter trust under his estate plan, and the remaining 10% to a marital trust. Velma is trustee of both trusts. She owns or controls 75% of the vote. At her death, however, the 20% of the voting stock in the credit shelter trust is not reported on her estate tax return, and she is considered to own two separate minority interests of 45% and 10%, which are not aggregated for estate tax purposes.

B. Impact of Valuation in Allocating Business Interests Post-Death

1. The control premium can work to the benefit of a taxpayer who desires to maximize the value of a majority interest which qualifies for a marital or charitable deduction. <u>See Estate of Chenowith v. Comm'r</u>, 88 T.C. 1577 (1987).

   EXAMPLE. D was the sole stockholder of Y Corp. At her death, 51% of the Y Corp. stock passed under D's will to her husband. D's personal representative and the IRS agreed that Y Corp. should be valued at $2,000,000, and that amount was included in D's gross estate. D's estate is entitled to a marital deduction for the 51% interest in Y Corp. bequeathed to D's husband. When calculating the amount of the marital deduction, D's personal representative is entitled to apply a control premium above the purely mathematical 51% of the value of all the Y Corp. stock. Thus, D's personal representative can claim a marital deduction for more than $1,020,000.

a. The Tax Court approved this result in Estate of Chenowith.

b. After D's death in the foregoing example, her husband could transfer 2 percent of the stock to a child or other descendant in order to reduce his interest below 51 percent and eliminate the control premium for purposes of valuing the stock in the husband's estate.

2. The same principles can work to the taxpayer's detriment if assets are not thoughtfully allocated. In Letter Ruling 9403005 (October 14, 1993), the IRS ruled that (1) a control premium applied to a decedent's majority interest in a corporation even though the stock would be split under his estate plan and pass as two separate minority interests, and (2) the minority interest passing to the surviving spouse should be valued as a minority interest for purposes of determining the marital deduction. The Tax Court reached the same result in Estate of DiSanto v. Comm'r, 78 T.C.M. (CCH) 1220 (1999).

EXAMPLE. F owned 80% of the stock of Z Corp. at her death. Z Corp. had an appraised value of $5,000,000 at F's death. An appraiser determined that F's controlling interest was worth $4,500,000. F's estate plan allocates half of the stock of Z Corp. to a marital trust for her spouse and half of the stock to her children. The IRS determines that each 40% interest, valued separately, is worth only $1,900,000. F's estate is entitled to a marital deduction of only $1,900,000, and the remaining $2,600,000 is taxable.

3. The result seems unfair, but the subtraction method inherent in the estate tax calculation (gross estate – deductions = taxable estate) mandates the result.

4. A corporate reorganization, to create voting and nonvoting stock, as previously described, can be accomplished post-death also. Doing this may facilitate additional post-mortem planning to minimize values in the survivor's estate.

EXAMPLE. J's estate plan resulted in 60 shares of the stock of his business being allocated to a marital trust and the remaining 40 shares of the stock allocated to a non-marital trust. After the trusts are funded, the corporation undertakes a stock split, issuing 9 shares of nonvoting stock for each share of voting stock. After the stock split, the marital trust sells 15 shares of voting stock (now with one-tenth of the pre-split value) to the Family Trust. After the sale, the stock is owned as follows:

Marital Trust	45 shares voting stock
	540 shares nonvoting stock
Family Trust	55 shares voting stock
	360 shares nonvoting stock

V. New Business Venture

A. The planning for succeeding to the wealth created by a business cannot start too early. A new business venture provides one of the best opportunities to remove future value from a person's estate. At the time of formation of a business venture, the value is limited, sometimes equal just to the actual equity investment of the owners less business obligations.

1. In a business venture that typically uses leverage, like real estate development, the initial equity value can be relatively small.

2. If the trust that will receive the equity interest in the new business venture is drafted with sufficient flexibility the client may feel comfortable transferring a significant equity interest at formation, even though his or her future plans for business succession are unknown.

   EXAMPLE. John is a real estate developer, concentrating in commercial developments and some multi-unit suburban apartment buildings. He and three other partners typically form a new LLC for each project. They minimally capitalize the LLC and borrow to acquire the land. Because of a long and successful history with such projects, the LLC is able to secure financing for 90% of the cost. They also are able to obtain construction loans for the actual development project. John's share of the initial equity investment in a new project will be $100,000. John would like to start transferring some of the profits from his various projects outside of his estate.

B. John has several options available for structuring his investment in a new project.

1. He can make gifts to his children and have each of them invest in the new project with him.

2. He can create an irrevocable trust for his children, or for his wife and children, gift funds to it, and the trust can invest alongside him.

   a. John's wife can be trustee or a co-trustee of the trust.

   b. If John's wife is a beneficiary, John in effect maintains future access to the trust property through her.

   c. John's wife could be given a lifetime power of appointment. This power could allow her to alter trust terms in the future to address future developments. This also could be accomplished through decanting, but use of a lifetime power reduces the fiduciary issues in connection with a decanting.

   d. The trust can provide for outright distribution to the children in the future, or it can be a generation-skipping trust.

   e. John should not act as a trustee of the trust who has any distribution authority, but he may act as a co-trustee with authority limited to investments or an investment adviser and thereby control investment decisions, as long as he does not thereby retain the voting rights for closely held stock he transfers to the trust. IRC § 2036(b).

   f. The trust can be structured as a grantor trust for income tax purposes. All items of income and deduction will flow through to John's income tax return. This creates a direct advantage for the trust, since its income will not be reduced by taxes, and enables future transaction opportunities.

3. John's partners, and the lending institutions, may not want a family trust to own a direct interest in the project. John also may not want to have the trust invest directly, as it may require disclosure of the trust terms to others. He can create a simple family LLC with himself and the trust as members. The LLC will be the direct investor.

   EXAMPLE: John creates an irrevocable grantor trust with his wife, Joan, and their three children as beneficiaries. Joan is trustee. John is investment advisor. He contributes

$100,000 to the Trust. Of that amount, $60,000 qualifies as annual exclusion gifts using the remaining exclusion he has available for the year for his children (the trust has Crummey powers). The remaining $40,000 is a taxable gift. John and the trust then form John Family LLC, and each contribute $50,000 to it. John Family LLC in turn contributes $100,000 to the LLC formed with John's partners for a new development project.

Three years later, the project is fully sold, and the LLC distributes $500,000 to the John Family LLC. Fifty percent of that amount is owned by the trust.

C. Once an irrevocable trust/Family LLC structure is in place, it can be used as a platform for a variety of additional planning.

1. The LLC can keep some or all of the funds and use them to invest in new projects. No new gifts from John are required.

2. If the LLC distributes funds to the trust, it can make other investments. The trust could use funds to purchase life insurance on John's life, eliminating or reducing the need for John to make annual gifts to the trust for the purpose of paying premiums.

D. Because the only members of the John Family LLC are John and a grantor trust, the LLC is a disregarded entity. It does not have to file a partnership tax return. It can buy assets from John, lend funds to John, or borrow from John, without having taxable events and without the interest on any loans being taxable.

E. <u>Issues in New Business Venture Planning</u>.

1. There are several aspects of new business venture planning structures that could create opportunities for the IRS to argue that the senior family member is making indirect gifts.

2. In the real estate development situation, are the partners providing services in connection with the project? If John is actually working on the project, for example in the lead developer role or as a construction manager, there may be assignment of income issues.

a. Often real estate developers have a separate entity that acts as "developer" and takes a separate fee. If that does not exist, it may need to be created.

b. In other businesses, the senior family member should take compensation for actual services, or have a separate GP interest, the return on which serves as his or her compensation income.

3. The active owners in the business likely are guaranteeing the loans they made to the business.

a. In situations in which a child or a trust for children borrows from a bank and the parent guarantees the loan, many estate planning professionals believe the IRS has a decent case for saying there is an indirect gift. <u>See</u> Letter Ruling 9113009 (taxable gift made by taxpayer who guaranteed loans made to corporations owned by his children) (withdrawn in Letter Ruling 9409018).

b. The value of the gift is unclear, and the IRS never has clearly set out a position that there is a gift at all.

c. Nevertheless, the safe approach is to have the child or trust pay a fee to the parent in exchange for the guarantee.

d. In other contexts, where the child or trust is a minority investor in a business venture, the existence of a gift as a result of the guarantees for loans to the venture is much less clear. That is especially the case where there are multiple third-party owners, and possibly other third-party investors who are not guaranteeing the loans.

4. At some point, the business is sufficiently formed that it has value over and above the net equity invested. This is why it is key to create an ownership structure in one of the forms described above as early as possible.

a. This is a significant issue with clients who are forming a private investment fund or hedge fund. While capital is a material factor, it is dwarfed by the impact of the services that the investment professionals/owners will be providing.

b. Once the owners have commitments from investors and sufficient personnel in place to have a viable operation, business appraisers conclude that the business has value based on its future potential cash flows.

(i) This is the case even though no money actually has been received, and the fund or funds have not officially launched.

(ii) The reputation and track record of the owners will impact the value of the business at this stage.

c. The same issues will arise in other businesses, although often the numbers will not be as significant as in private investment funds.

VI. <u>Matching Transfer Techniques With The Types of Business Interests</u>

A. For an existing, more mature operating business with significant value, the practitioner must deploy his or her full toolbox of asset transfer techniques.

1. In transfer tax planning for a business, one size does not fit all. The technique must make sense for that business, based on how it is organized and its financials.

2. The technique also must make sense in light of the current plans for succession.

a. As noted, the primary owner may not yet have a firm vision of the future.

b. When the business owner does have a firm plan in mind, this may dictate certain actions for transferring ownership, or open up options.

c. For example, it is much easier to implement a sale of a grantor trust for a note if there is a clear plan to sell the business in five to ten years. The sale proceeds then can be used to pay the note.

d. In a business that will continue and which focuses primarily on reinvesting its cash flow, a sale for a note may not be the best choice because there is no clear path for ultimately paying the debt.

B. Transfers of Business Interest With No Cash Flow.

EXAMPLE. Mary is the sole owner of Full Circuit, Inc., a successful business manufacturing specialty electrical parts. She inherited the business from her father and has expanded its scope and success significantly. Key to the success has been intensive capital investment in new computerized manufacturing machinery. She also has built a new manufacturing plant. To accomplish this, Mary has reinvested 100% of Full Circuit's profits. She believes she must continue to do this for at least the next ten years to maintain the company's success. At the same time, she recognizes that the value of the business is increasing and creating estate tax problems for her. Mary acknowledges that the business' success and need for capital could eventually cause her to sell the business. But, she wants to minimize the value of the business in her estate, in case she dies unexpectedly or later decides that the business should be preserved for her descendants.

1. Mary and Full Circuit, Inc. represent the most challenging business succession situation. The value of the business is increasing. Mary would like to move some of the value out of her estate. But she cannot afford to divert cash flow from the business that could be used to finance an installment of stock or other techniques discussed in the following sections.

2. This is a situation where it is difficult to transfer significant value. Nevertheless, the client should at least take the steps that are readily available. Those basic steps are:

    a. Determine the value of the business as a whole and the value of shares on a minority/non-marketable basis.

    b. Use lifetime gift tax exclusion and annual exclusion gifts to transfer stock so that some future growth can start accruing outside Mary's estate.

    c. Consider use of a Grantor Retained Annuity Trust ("GRAT") to transfer excess appreciation out of the estate with no additional tax cost.

3. Lifetime giving helps to reduce estate taxes by removing assets, and future appreciation on assets, from the business owner's estate. Lifetime gifts can take the form of annual exclusion gifts or larger taxable gifts that use applicable exclusion amount or result in the payment of gift tax.

    a. An annual exclusion gift removes both the current asset value and future appreciation and income from the donor's estate.

    b. A taxable gift does not remove the current value of the asset from the donor's estate. If the asset never appreciated following the gift, there would be no benefit from the gift (and possibly a detriment to the extent of a lost step-up in basis if the asset has been retained until death). However, all future appreciation and income does escape tax in the donor's estate.

4. In addition to removing current value and future appreciation of the business from the donor's estate, lifetime gifts of business interests can provide several significant benefits. Gifts of small blocks of company stock put the donor in the position to take maximum advantage of valuation discounts. Lifetime gifts of small amounts of stock permit the donor to use minority interest discounts. These discounts may not be available to the same degree when the stock is subject to estate tax at death.

5. Gift planning is often preceded by a change in the capital structure of the company to create a class of non-voting common stock, as previously discussed.

    EXAMPLE: Mary obtains an appraisal of Full Circuit, Inc. The appraiser determines that it has a value of $20 million on a non-marketable controlling basis. Mary first recapitalizes the company by doing a stock split and issuing 49 shares of nonvoting stock for each share of voting stock. Assume there are now 100 shares of voting stock outstanding ($4,000 per share using the above valuation) and 4,900 of nonvoting stock (also $4,000 per share using the above valuation). Mary transfers half of the voting stock to her husband Larry.

Mary then makes a gift of nonvoting stock to an irrevocable trust and uses some of her and Larry's applicable exclusion amounts. Assume the appraiser concludes a 15% minority interest discount is appropriate. Mary values the stock at $3,400 per share for purposes of the gift, and transfers 611 shares (611 shares x $3,400 = $2,077,400).

Mary also makes annual exclusion gifts to the trust (it has Crummey powers) for each of her three children. Using gift splitting, she transfers an additional 24 shares (8 shares x $3,400 = $27,200 x 3 children). Mary now owns 50 voting shares and 4,265 non-voting shares. She owns 86.3% of Full Circuit, Larry owns 1% (but half the voting stock) and the irrevocable trust owns 635 shares, 12.7%.

Assume Mary is able to transfer 46 more shares via annual exclusion gifts over the next two years, increasing the irrevocable trust's ownership to 681 shares, or 13.62%.

Mary's interest in the business is still significant and the value is increasing. Assume that, after two additional years of gifts, the stock has a value of $4,200 per share on a non-marketable minority basis and $4,940 per share on a non-marketable controlling basis. In other words, the entire company is now worth $24,700,000 on a non-marketable controlling basis.

Mary's 500 voting shares and 4,219 nonvoting shares should be valued as a minority interest, so the value of the stock in her estate is $19,819,800 (4,719 x $4,200 per share) -- $4,880,200 less than if she had not done the lifetime planning described above.

6. As illustrated in the example above, Mary's use of her lifetime exclusion amount and annual exclusion gifts can lead to a transfer of significant value out of her estate. But, with the business value increasing, her own estate does not shrink much in size. If the value of the business grows at even a faster pace, she needs something more to keep her estate from increasing rapidly.

7. A Grantor Retained Annuity Trust ("GRAT") may provide a way for Mary to transfer excess growth than the business out of her estate.

8. In a GRAT, the grantor retains the right to receive fixed annuity payments (payable at least annually) for a term of years or the prior death of the grantor. The transfer of property to a GRAT constitutes a gift equal to the total value of the property transferred to the trust, less the value of the retained annuity interest. The annuity does not have to be an equal amount each year. It can be defined as a fixed initial amount, increased by up to 20% in each subsequent year. At the end of the term, the grantor receives no additional benefits from the trust. The remaining trust principal is either distributed to beneficiaries (such as the grantor's descendants) or held in further trust for their benefit. If the grantor survives the term, that trust principal is excluded from the grantor's estate for federal estate tax purposes.

9. Most GRATs provide that the annuity payout amount must be satisfied from trust principal to the extent trust income in a given year is insufficient. The IRS has ruled privately that Section 677 applies where the annuity may be satisfied out of trust income or principal. <u>See</u> <u>e.g.</u>, Ltr. Rul. 9415012 (January 13, 1994). Therefore, virtually every GRAT should be treated as a grantor trust with respect to all trust income. This is important in business planning. It means that a GRAT can be funded with stock in the business, and that stock can be paid back to the grantor to satisfy the annuity obligation without the distribution of the stock being treated as a sale.

10. The GRAT is particularly attractive for individuals who have used their applicable exclusion amount but still want to transfer wealth to others. A "zero-out GRAT" can be used so that there is no gift tax consequences to the creation of the trust. By structuring the GRAT so the value of the annuity equals the value of the property transferred, the taxpayer can avoid using applicable exclusion or paying gift tax. If the transferred assets increase significantly in value during the term of the GRAT, some of that appreciation is transferred out of the taxpayer's estate tax free.

a. A zero-out GRAT often works best when the annuity term is short (such as two or three years) and the GRAT is funded with one stock. A single stock that performs well during a two- or three-year period easily can grow at an annual rate of 20% or more over that time frame.

b. The property transferred to a short term GRAT needs to sustain a high growth rate for only a short period of time for the GRAT to be successful. If the property does not appreciate as anticipated, it all is returned to the grantor in the annuity payments. The grantor then can create a new GRAT.

c. These attributes fit well with closely held stock. The owner can use a GRAT to try to shift additional stock out of his or her estate, at no tax cost. The stock does not have to grow at a tremendous rate for the GRAT to have some benefit. As long as the stock grows at a rate greater than the assumed IRS rate used in determining the gift, there will be some benefit.

EXAMPLE: After Mary funds the irrevocable trust, she transfers 4,200 of her remaining non-voting shares in Full Circuit to a 3-year GRAT. The stock is valued at $3,400 per share, so the total transfer is $14,280,000. The IRS Section 7520 rate in the month of the transfer is 2.6%. Mary retains an annuity of 29.0032% ($4,141,657) payable at the end of the first year, increased by 20% in each of years 2 and 3. The annuity has a value of $14,280,000, so no gift is made when Mary creates the GRAT. The stock increases in value to $3,600 per share after one year, $4,000 per share after two years, and $4,200 per share at the end of three years. The GRAT operates as follows:

Year-End	Annuity Payable	Value Per Share	Shares Paid to Mary	Shares Remaining
1	$4,141,657	$3,600	1,151	3,049
2	$4,969,988	$4,000	1,243	1,806
3	$5,963,985	$4,200	1,420	386

d. In this example, the GRAT removes 386 shares from Mary's estate, with a value of $1,621,200 at the end of the three-year term.

e. The Section 7520 rate makes a meaningful difference in the success of the GRAT. If the rate was 5.8% was the GRAT was created, only 133 shares (value $558,600) would have been transferred out of Mary's estate.

f. If the value of Full Circuit increases significantly over this time-period, the benefit of the GRAT is far greater. In effect, the GRAT allows Mary to shift most of this additional appreciation out of her estate.

EXAMPLE: Assume the stock in Full Circuit increases in value by 15% in each of the first two years and 20% in the third year after Mary creates the GRAT. The GRAT operates as follows:

Year-End	Annuity Payable	Value Per Share	Shares Paid to Mary	Shares Remaining
1	$4,141,657	$3,910	1,060	3,140
2	$4,969,988	$4,495	1,106	2,034
3	$5,963,985	$5,395	1,105	929

g. In this example, Mary has moved 929 shares out of her estate, with a value of $5,011,955 at the end of the three-year term. Overall in this example, Mary's 4,200 shares originally transferred to the GRAT are worth $5,019,000 more after three years than in the prior example. The GRAT moves 99.8% of this additional appreciation ($5,011,955/$5,019,000) out of Mary's estate.

11. If voting stock in a closely held corporation (one in which the grantor and related parties own 20 percent or more of the voting stock) is transferred to the GRAT, the grantor should not retain the right to vote that stock beyond the date that is three years before the end of the annuity term. The right to vote the stock will cause the stock to be included in the grantor's estate under Section 2036(b), and the relinquishment of that right within three years of death will cause inclusion under Section 2035(d). If the grantor retains the right to vote the stock until the end of the annuity term, he must survive an additional three years to ensure that the property will be excluded from his estate. This problem can be avoided by using non-voting stock.

12. At the end of the annuity term, the property in the GRAT can be distributed outright to the grantor's children or other beneficiaries, or retained in trust. One advantage of retaining the property in trust is that the grantor's spouse can be a beneficiary, thereby permitting the couple to have some access to the property during the spouse's life and causing the trust to continue to be a grantor trust.

a. The spouse also can have a power of appointment over the trust property. If the couple decides that the GRATs have been too successful in moving property out of the grantor's estate, the spouse could use the power of appointment to divert some of the trust property to other relatives or to charity.

b. This also can be accomplished with a cap provision in the trust, whereby any value over a certain threshold is diverted to charity.

c. A business owner may find provisions like this particularly useful if the business is sold at a very high value. The individual may view that wealth set aside for her children in a different light when it is in a liquid form.

13. GRATs have a significant advantage over other gifting techniques because of the ability to define the retained interest as a percentage of the initial value of the gifted property "as finally determined for federal gift tax purposes". Thus, if the gift value is doubled, so is the retained annuity, and there is little or no increase in the amount of the gift. Thus, the audit risk with a GRAT is much reduced.

C. <u>Transfer of C Corporation Stock Where Cash Flow is Available</u>

1. If the client has a C corporation that has sufficient cash flow to make distributions, the techniques discussed in the preceding section will work even better. Having cash flow creates additional opportunities. For example, if the client makes a $1,000,000 gift of dividend paying stock to an irrevocable trust, the accumulated dividends can be used to purchase additional shares of the stock over time. In a GRAT, cash flow can be used to help satisfy the annuity payments.

2. In addition to the transfer tax benefits, there can be benefits related to family cohesion and support of the business. For dividend paying businesses, gifts of stock will give family members a stake in the income from the business and perhaps instill more of an interest in the business' success, as opposed to personal agendas.

3. Even when a C corporation is generating cash flow that it can distribute, the client often does not want to pay significant dividends, because the distributions are taxable to the stockholders. (At the current 20% rate applicable to qualified dividends, there has been less reluctance to pay dividends as there was many years ago.) One way to make a more estate planning focused use of dividend income is through the creation of preferred stock.

D. <u>Preferred Equity Interests</u>.

1. Preferred stock, or preferred partnership interests in a business organized as a partnership, can be issued to concentrate income from the business in one or more family members who require extra revenue.

2. The traditional estate planning use of preferred stock has been to use it to freeze the value of a senior generation owner's estate and shift future appreciation to the next generation.

EXAMPLE: Eddie Entrepreneur owns a small but promising business worth $2,000,000. His children and trusts for their benefit own about 50% of the business, which they have received through gifts. Eddie recapitalizes the company and exchanges his $1,000,000 of common stock for $1,000,000 of fixed value preferred stock with a 7.5% preferred dividend. Over the next ten years, the value of the company grows to $20,000,000. Eddie's interests is still worth $1,000,000, and his children and their trusts own common stock worth $19,000,000.

3. The foregoing example provides another illustration of a situation where too much successful planning can turn into a negative if the business is sold. If all the growth is in the hands of the children or trusts for their benefit in this example, Eddie may not like receiving such a small portion of the proceeds in a sale.

4. Another goal in issuing preferred stock is to let some family members participate more in the income of the business while others receive more of the growth.

a. Preferred stock can be issued to a retiring family member as part of his or her exit strategy to ensure that the family member receives a steady income stream after retiring.

EXAMPLE: One of the siblings in a family-owned business is approaching retirement. She owns $10,000,000 of common stock in the business. The company pays a modest dividend, and she receives about $100,000 of dividend income annually. The company issues $5,000,000 of preferred stock to her in exchange for $5,000,000 of her common stock. The preferred stock pays an 8% preferred dividend. After the exchange, she will have about $400,000 of dividend income per year.

b. An individual may want to leave preferred stock to a surviving spouse to provide funds to maintain his or her lifestyle.

5. A recapitalization and gift planning using preferred stock of course must comply with Code Section 2701 in order to obtain the desired transfer tax results. That means use of a cumulative preferred dividend and other attributes so that the preferred stock is not assigned a value of zero for gift tax purposes.

6. For some companies, it may be preferable to continue to pay a salary to a retiring shareholder, since a reasonable salary is deductible by the corporation and dividend payments are not. Other companies may want to minimize salary payments in an effort to improve the net revenues from operations, as shown on their financial statements.

E. Transfer of S Corporation Stock

1. An S corporation will be unable to engage in a preferred stock recapitalization, since it cannot issue preferred stock. It also will not be possible to use the stock to fund a partnership or LLC, since an entity taxed as a partnership is not a permissible holder of S corporation stock. However, like any flow-through entity, the S corporation can make distributions without an immediate tax cost.

   a. This fact, and the fact that an S corporation typically does make distributions at least sufficient to cover the shareholders' tax liability attributable to S corporation earnings, creates significant opportunities to transfer S corporation stock.

   b. If the owner transfers S corporation stock to a form of irrevocable grantor trust, he or she can use the cash flow distributed for tax purposes in effect to help finance the transfer of the stock.

   c. An S corporation may only have certain types of trusts as shareholders. However, a grantor trust will qualify as a shareholder of S corporation stock.

2. The GRAT can be a particularly advantageous way to transfer stock in an S corporation. Because the S corporation is a flow-through entity for income tax purposes, the trustee of a GRAT is able to satisfy part or all of the annuity payments with pre-tax dollars from the corporation.

3. Likewise, the distributions of pre-tax dollars can be used in a sale of S corporation stock for a note.

   EXAMPLE: Carlos creates an irrevocable grantor trust and funds it with a gift of $200,000 of stock in his S corporation. The trust is structured as a grantor trust. Carlos then sells $1,800,000 of the stock to the trust for a 9-year installment note, bearing an interest rate of 2.0% (the mid-term applicable federal rate). The company distributes cash of about 6% per year based on the discounted value of the stock, and the stock is also appreciating at about 5% per year. The trust will receive distributions of $120,000 per year. This allows the trust to pay all the interest to Carlos and make significant principal payments on the note each year. At the end of 9 years, and the stock will have a value of $3,102,655. There is only $554,589 remaining on the note.

4. The foregoing example does not have the "perfect" outcome. There is still a balance due on the note. Reality often works that way. Maybe Carlos thought the business would generate some excess cash flow, and it did not, or that excess cash flow was needed in the business. But the trust and Carlos still have a number of options.

   a. Use stock to repay the balance on the note.

   b. Extend the note at the then current AFR. It is not significantly different, the trust needs about three more years to pay off the note.

   c. Make a gift to forgive part or all of the note.

VII. Estate Planning Transfers Shortly Before Sale

A. Can one of the previously described lifetime planning techniques be used shortly before a sale of the business to a third party? Yes, many people would respond, but with little or no valuation benefit if a deal already is under negotiation.

B. Business appraisers, however, can provide support for the position that uncertainties inherent in any major sale transaction prior to closing will allow for some discounting. The extent of the discounts will depend on the uncertainty inherent in the particular deal, and the amount of time before closing. These factors, in addition to the deal terms such as escrow provisions, and earn-out provisions, make the current value of a business interest less than a listed sales price.

C. An excellent, succinct summary of how an appraiser analyzes these factors can be found in Radd L. Riebe, "Discounts Before The Deal is Done," Trusts & Estates, at 37 (December 2007).

1. Riebe uses the illustration of a situation where a letter of intent has been signed to purchase a private company for $100 million. Under the proposed structure of the transaction $80 million will be paid at closing, $5 million of which will go to an escrow account payable 24 months after closing if no environmental or product liability issues arise. The remaining $20 million is an earn-out, to be paid over time based on the business achieving certain performance benchmarks.

2. In determining the value of stock in the company for purposes of a lifetime transfer, Riebe explains that an appraiser first would need to present value the future payouts. That might reduce the maximum present value of the deal to, for example, $95 million. Id. at 38.

3. The appraiser then would analyze the expected value of the stock if the deal goes through (the "transaction scenario") and if it does not take place (the "non-transaction scenario"), with the transaction scenario analysis also weighing the possibility that the escrow and earn-out amounts may not be fully realized. The non-transaction scenario examines the risks of factors such as due diligence issues, representations and warranties, and financing contingencies sinking the deal. This analysis results in a probability weighted expected value for the deal. In Riebe's example, this is $88,750,000. Id. at 38-40.

4. A final step is subtract an arbitrage discount to reflect the risk that the two potential outcomes have significantly different results for the hypothetical buyer. In the example that discount is $1,518,750, resulting in a value of $87,231,250. Id. at 40-41.

D. Thus, the hypothetical business owner in this example, who has chosen the exit strategy if selling to a third party, could still engage in some lifetime transfer tax planning and achieve a discount from the contract price of more than 12.5%.

VIII. Gift of Stock to CRT Shortly Before Sale or Redemption.

A. When the succession plan for the business ends up being a sale, charitable giving can play a role in the pre-sale planning.

B. Many donors begin thinking about a gift of appreciated assets to a charitable remainder trust (or other charitable entity) only after a contract for the sale of the assets is in place. The IRS will impute gain to the donor when such a transaction is already in place.

EXAMPLE. Bruce is planning to sell his business. He estimates that he will receive $80 million for it. In addition to many other new activities that he plans to undertake with his new-found wealth and free time, he would like to become more charitably involved. He is considering creating a foundation. However, his wife has expressed concern that he might get too carried away with his spending and charitable giving and not leave enough for her long-term security. So Bruce committed to putting $10 million into a CRUT for himself and his wife. Bruce has retained an investment banker, who is nearly ready to start marketing the company and soliciting offers.

C. A key question is how close a potential donor like Bruce can come to a signed contract without causing the gain to be imputed back to him. There is no bright line test when a sale to a third party is involved. The general standard is whether the right to receive the income (the sale proceeds) has ripened to the point where the transfer of the stock is equivalent to the transfer of the proceeds.

1. In Martin v. Machiz, 251 F. Supp. 381 (D. Md. 1966), the donor negotiated with a prospective purchaser of stock in his closely held corporation. While negotiating, the donor told his attorney to prepare a charitable remainder trust. The donor transferred his stock to the charitable remainder trust. Two days later, the trustees (donor and his lawyer) sold the stock to the buyer with whom the donor had previously negotiated. The court found that the trust was not legally obligated to sell the stock. Therefore, the gain could not be imputed to the donor.

2. In Ferguson v. Commissioner, 174 F.3d 997 (9th Cir 1999), members of the Ferguson family were in the process of selling their company and planning at the same time to donate stock to charities. On August 3, 1988, a third party made a tender offer to purchase the Ferguson's company. On August 15 and 16, the Fergusons notified the Mormon Church that they were donating shares to it. On August 26, they organized two private foundations to which they also planned to donate shares. On September 12, 1988, the acquiring entity announced that the necessary 85% of the company's stock had been tendered and that it accepted all the tendered stock. The actual transfer of the stock by the Fergusons to the church and the private foundations took place on September 8 or 9. The court subsequently determined that the stock had ripened from an interest in a corporation to a fixed right to receive cash on August 31, 1988. Therefore, the Fergusons had to recognize the capital gain on the shares acquired by and sold by the charities.

D. In situation in which the shareholder donates stock to a charitable entity, and the corporation then redeems the stock from the charity, the prevailing law is less onerous.

1. In Palmer v. Comm'r, 62 T.C. 684 (1974), a donor had voting control of both a closely-held corporation and a private foundation. The donor contributed stock of the closely-held corporation to the foundation, and the corporation then redeemed the stock. The IRS argued that, in fact, the corporation redeemed the stock from the donor, and the donor then contributed the proceeds to the foundation. The Tax Court, however, respected the transaction, primarily on the basis that the foundation was not obliged to go through with the transaction.

2. As a result of Palmer, the IRS issued Rev. Rul. 78-197, 1978-1 C.B. 83, which states that "the Service will treat the proceeds of a redemption of stock under facts similar to those in Palmer as income to the donor only if the donee [the charity] is legally bound or can be compelled by the corporation, to surrender the shares for redemption."

3. In Blake v. Comm'r, 697 F.2d 473 (2d Cir. 1982), the Court of Appeals went further and said that a mere understanding between the donor and the charity is sufficient for the imputation of gain to the donor. However, the IRS position from the Revenue Ruling generally has been followed by the courts in the redemption context.

E. If Bruce creates the CRUT and funds it with stock before the investment banker has even started to solicit offers, he should be safe. The problem often is that the owner is not willing to commit the stock to the CRUT until the owner is confident that the sale will go through.

EXAMPLE: At the time the sales materials are first being distributed, Bruce transfers $10 million of the company stock to a CRUT that pays 6% to himself and his wife for their lives. When the company is sold, the CRUT pays no capital gains tax on the stock. The full $10 million is reinvested and Bruce and his wife initially receive $600,000 per year. If Bruce is 60 and his wife is 61, the value of the charitable deduction for creating the CRUT is slightly more than $2,200,000.

F. The CRUT can be drafted with some flexible features that will give the grantor a number of options in future charitable planning.

1. The grantor can retain a power to name substitute charities for the charities designated in a CRT, or can give this power to another. See Rev. Rul. 76-8, 1976-1 C.B. 179.

2. The power also can be in the form of a testamentary power of appointment. See Rev. Rul. 76-7, 1976-1 C.B. 179.

3. As trustee, the grantor also could retain the right to distribute additional amounts to charitable organizations during the term of the unitrust payments.

4. This can be an appealing alternative for a client who is not ready to commit to a private foundation, but may not want to retain the full amount of the unitrust interests for life.

IX. Children With Ownership Interests Come of Age

A. A significant non-tax issue for family business owners is the ownership of stock by younger family members and the possibility that non-descendants, in particular spouses, may acquire rights to the stock, such as through divorce, community property laws, or the death of the descendant. In other words, a shareholder may find themselves having to involuntarily liquidate part of the ownership interest. This is extremely unfortunate for that shareholder and also can be disruptive to the business and other shareholders.

EXAMPLE. Marina is the controlling shareholder of a family business with a value in excess of $100 million. Her parents started the business and transferred some of the stock to trusts for Marina's four children as part of their estate planning. Marina also has made annual gifts of stock into trusts for the children since they were young. The generation-skipping trust created by Marina's parents operates as a one-pot trust until Marina's youngest child is 21, then divides into separate trusts for the children. Each child has rights to withdraw one-half of the trust property at age 25 and the rest at age 30. Marina didn't think she wanted to tie stock up for her children when she first started making gifts, and she didn't like the complications of a Crummey trust, so the trusts she created were 2503(c) minor's trusts that terminate at age 21. Marina now comes to you concerned about the stock that will be transferred outright to her children as they get older. She has two children over 21, but she has not bothered to terminate their 2503(c) trusts. Her oldest child told her he will be getting engaged shortly. Marina is concerned about marital rights her future daughter-in-law might acquire in the stock.

B. Several courses of action should be considered – all of which might be appropriate, but not all of which might be practical based on the realities of the situation.

1. Prenuptial agreements for children (and later grandchildren) before they marry.

2. Long-term trusts to hold stock interests transferred to descendants.

3. A buy-sell agreement for the company and its shareholders.

C. Prenuptial Agreement

1. A prenuptial agreement is a familiar tool in a wealthy family. It is used to try to protect family wealth by limiting the rights of a spouse to receive property at death or upon divorce.

2. Prenuptial agreements are recognized in virtually every U.S. jurisdiction, but are generally strictly scrutinized by courts for fairness and equity. In general, they require that each party be represented by separate counsel, that there be sufficient disclosure of assets so each party is fully aware of what property rights they are giving up, that there be no undue influence or pressure in procuring the agreement (no signing at the back of the church), and that the agreement not leave the less wealthy spouse completely impoverished upon divorce or death.

3. It is often very difficult to sell the idea of a prenuptial agreement to a young couple neither of whom has been previously married. It seems to, and in some respects does, run counter to everything they are promising each other upon their marriage. Sometimes the couple, or one of them, will refuse to consider an agreement.

4. One possible way to present the agreement is to limit it just to the stock in the family business and tie the limitations to the heritage of family ownership.

    a. The agreement would provide that the stock cannot be considered marital property or property subject to a spousal election under any circumstance, and must be kept in trust if passing at death.

    b. However, the agreement would not restrict or otherwise alter applicable law with respect to income from the stock, or proceeds if the stock is sold.

D. Trust planning

1. The senior generation can provide significant protection for the family business by making sure that stock is transferred in trust and stays in trust.

2. If the stock is not owned outright by descendants and will not pass to them at designated ages, it will not be available for division in the case of divorce and generally should not be reachable by creditors.

3. The use of long-term trusts is not necessarily inconsistent with giving descendants significant control.

    a. The grantor/decedent can designate that the child can become a co-trustee of his or her trust at a certain age, and, in most states, become sole trustee at a certain age.

    b. If the beneficiary as trustee can make distributions only subject to an ascertainable standard and is prohibited from using trust property to discharge legal obligations, he or she can act without causing the property to be included in his or her estate.

    c. If state law prohibits the beneficiary from acting as sole trustee, the beneficiary still could be named as an advisor with respect to the family business assets, and have substantial control over voting and decision-making with respect to those assets.

    d. The beneficiary also can be given lifetime and/or testamentary powers of appointment.

4. In a situation like Marina's, where there are existing irrevocable trusts, it may be possible to modify the trusts through merger provisions in the trust agreement or via state law decanting statutes. For example, if it had been thought of before the children turned 21, it might have been possible to merge existing Section 2503(c) trusts with new Section 2503(c) trusts that provide a 30-day withdrawal right at age 21, but with the property staying in trust if that right is not exercised.

5. The generation-skipping trust created by Marina's parents presents a greater challenge. Decanting might provide a solution. This is an example of a situation where built-in flexibility when the trust was drafted would now serve the family well. For example, if Marina had a lifetime power of appointment over the generation-skipping trust, she could use it to alter the withdrawal rights given Marina's children.

6. For Marina's two oldest children, who are over age 21, there is no option to continue the existing trusts. One alternative is to ask each child to create a revocable trust with the stock, with another family as trustee or co-trustee, and revocable only with another family member's consent. The protection is not likely to completely insulate the stock from creditors or the claims of a spouse, but it is better than nothing. If the interests are sufficiently valuable, consideration can be given to having the child create a domestic asset protection trust in a jurisdiction with a DAPT statute.

E. Any of the preceding planning steps should be reinforced with a buy-sell agreement among the shareholders and the company. A buy-sell agreement provides the ultimate protection for the company itself, by providing the company or other family shareholders with the ability to purchase stock from an undesirable shareholder.

F. The buy-sell agreement is a contract among the owners of a business, or between the owners and the company, which sets out what will happen to their various ownership interests upon the occurrence of certain specified future events (such as death or withdrawal). Buy-sell agreements are used primarily to achieve non-tax goals. They can serve a number of useful purposes in a family business, before, during and after a period of succession.

1. Control. A typical agreement will give the entity, the owner, or both a right of first refusal on certain proposed transfers by a shareholder. This protects the existing owners from unwillingly becoming business partners with an undesirable owner. It may permit a senior family member who controls the business to become comfortable with making gifts of stock, since the agreement will give him or her some control over what his children do with the stock.

2. Liquidity. A buy-sell agreement can provide a withdrawing family member with a market for his or her interest by providing a put right in certain circumstances. The most common point in time to grant a put right is at the death of a shareholder. It allows a surviving spouse or children who are not interested in continuing in the business to liquidate their interest. Put rights also can be granted at retirement or when the shareholder ceases to be employed with the business for other reasons.

3. Planning. A buy-sell agreement helps push a family toward further succession planning by focusing them on what options should be given to the family of a deceased shareholder and how to fund the repurchase of stock under the agreement.

4. Preservation of Tax Benefits. It is also possible to include in a buy-sell agreement prohibitions against certain actions by the shareholder that would threaten tax elections. A buy-sell agreement for an S corporation typically prohibits a shareholder from transferring stock to an entity or person that is not a permissible shareholder of an S corporation, or from taking any other action that would threaten the S election.

G. Once it is determined that a buy-sell agreement is desirable, the next determination must be who the operative parties to the agreement will be. Obviously, the withdrawing party will be the seller, but the purchaser may be the other owners (a **cross purchase**), the business itself (an **entity purchase**), or a combination of the two. Except to the extent that tax consequences may vary, the seller is generally not concerned with the question of who acts as the purchaser (assuming that the purchase price terms are the same). He is concerned only with getting the appropriate amount of money for his interest. However, it is important that the purchaser be identified and that steps be taken to ensure that the purchaser has the funds necessary to make the required purchase.

H. Cross-Purchase Agreement.

1. A buyer will often prefer a cross-purchase agreement since this will result in an increase in the buyer's basis in his stock. If the other shareholders are to make the purchase, it is often desirable for them to take out insurance on one another's lives so that funds will be available to make the purchase. Obviously, with a large number of shareholders, this can be very expensive as well as administratively cumbersome. If this type of cross-purchase arrangement is structured, at the death or withdrawal of one shareholder, the policies he holds on the lives of the other shareholders must be assigned to the remaining shareholders. Younger shareholders may bear a disproportionate burden of the cost of such agreements because the policies on the lives of the older stockholders, which they must purchase, will have higher premiums than the policies on their lives, which the older stockholders must purchase.

2. Generally, the cross purchase of insurance by the shareholders is not associated with any adverse income tax consequences. When the surviving shareholders receive the insurance proceeds on the deceased shareholder's life at his death, those proceeds will not normally constitute taxable income to them. When they purchase the stock from the decedent's estate, no significant taxable gains should occur because, by reason of the decedent's death, the estate has received a step-up in the income tax basis of the stock being sold. Moreover, the full amount paid for the stock so acquired is included in the surviving stockholders' income tax basis for that stock, so any subsequent sale of the business by them would result in their realizing less capital gain.

3. Although no income tax problems generally result from cross-purchase agreements, if the insurance policies are transferred among the remaining owners, problems can arise as a result of changes in stock ownership. In these cases, assignments of the policies may run afoul of the "transfer for value" rules of the tax law (IRC § 101(a)(2)) and may cause the proceeds of the insurance to be fully income taxable when the transferee shareholder collects them.

4. If corporate earnings are to be the principal source of premium payments, additional problems are created. When the shareholders own the policies, any premium payments by the corporation will be income to the shareholders. If the company owns the policies but distributes the proceeds to the surviving shareholders to allow them to make the purchase, the proceeds may be a taxable dividend.

I. Entity Purchase Agreement.

1. Alternatively, the buy-sell agreement can be structured to have the business itself (rather than the other owners) be the ultimate purchaser at the time of the withdrawal or death of any of the owners.

2. This alternative may seem attractive if the corporation has sufficient funds to effect the purchase; however, accumulating such funds could cause the corporation to run afoul of the "unreasonable accumulation of earnings" provisions in the income tax law. IRC §§ 531-537.

3. If the corporation does not have sufficient funds to effect purchases at the death of an owner, it could acquire insurance for such purchases. Only one policy on the life of each shareholder would be necessary, and there would be no need for transfers of policies, eliminating concern over the "transfer for value" rules. Further, the cost differences of policies between shareholders of various ages are equalized (because the corporation pays for all policies).

4. The receipt of insurance proceeds by a C Corporation may have income tax consequences.

    a. Under Code Section 101(j), a corporate-owned policy issued after August 17, 2006, on an employee's life is non-taxable only to the extent of premiums and other amounts paid for the policy unless certain notice and consent requirements are met.

    b. While insurance proceeds received by the corporation are not subject to regular income tax liability, they are taken into account in determining the corporate alternative minimum tax. This may result in additional tax owed by the corporation.

5. Although having the corporation serve as the purchaser in the buy-sell agreement may appear desirable, there are certain disadvantages. First, such purchases constitute redemptions for income tax purposes. As is discussed later in the materials, unless certain very specific requirements are met, the amounts distributed from the corporation for the stock interest constitute dividend income to the recipient. The tax consequences of this to the recipient would be undesirable in that the proceeds, instead of being nearly tax free, would be taxable as ordinary income. Accordingly, in structuring a corporate redemption, one must ensure that the redemption will qualify as (a) substantially disproportionate, (b) a complete termination of interest, or (c) a redemption to pay death taxes.

6. Moreover, the remaining shareholders may face potential capital gains problems. When the selling shareholder's shares are purchased by the corporation, the value of the remaining owners' shares may increase, although their income tax basis in the shares will not. The value of the corporation, and accordingly the outstanding stock, may also be increased by the receipt of insurance proceeds by the corporation. A subsequent sale of a remaining shareholder's interest may thus result in a large capital gain.

7. One final potential tax trap with regard to buy-sell agreements should be recognized. Sometimes such agreements are structured to require the surviving shareholders to purchase the stock at the death of one of them, but then, at the time of sale and purchase, it is determined that the corporation has adequate funds to make the purchase. Even if it is possible to structure a purchase by the corporation that will not be taxable as a dividend to the recipient, an unintended dividend to the surviving shareholders may be imputed for income tax purposes. This would be the case if a primary, unconditional obligation of such shareholders (the requirement to purchase the stock) were satisfied by the corporation. To avoid this result, the buy-sell agreement should generally not impose a primary unconditional obligation on the surviving shareholders but should give the corporation the first right to purchase and should make the shareholders obligated to purchase only if the right is not exercised.

X. Buy-Out of a Family Member

A. As a family business is dispersed among several generations, it is inevitable that one or more family members will want to sell out. This sets up several possible conflicts in personal beliefs and philosophy, any or all of which will be exacerbated by the emotions of family relationships.

1. Some family members may feel strongly that the business is a key element of the family heritage and no one should be allowed to leave.

2. A family member often wants to sell because they have been excluded from working in the business. The classic example is where son is left in charge and son and his family hold all the key positions in the business. Daughter or daughters and their families still are owners but not active. Or, a family member may have chosen a line of work outside the business but is jealous of siblings or cousins who work in the business and receive special benefits as a result.

3. The family members who strongly support the business may view the dissatisfied family member as ungrateful and having unrealistic expectations about being made wealthy by stock that he or she inherited (and never "earned").

4. The dissatisfied family member may view the business interest as a burden: it complicates life and forces him or her to engage in expensive tax-planning because of the future estate tax burden. That family member may be unsatisfied with the level of distributions. He or she also may maintain the view that his or her interest should be repurchased based on a percentage of the value of the entire business. The family member views valuation discounts as an invention of the business lawyers, in order to force her to sell for less than she deserves.

   EXAMPLE. Smith Metals, Inc. is a successful business currently owned and operated by the G2 generation – two sisters and a brother. All three G2s work in the business, as do several of the G3s. The two children of one of the sisters, Jayne, have never worked in the business and have no interest in it. These two children own a small amount of stock directly, and larger amounts in trusts Jayne established for them. They each also are beneficiaries of a generation-skipping trust created by their grandparents. That trust holds about 30% of the stock in Smith Metals, Inc., and terminates at the death of the last to die of the three G2s. At that time, assuming all G3s are alive, it would be distributed outright in seven shares. Jayne's two children would like to sell their interests in Smith Metal's, Inc.

B. In a healthy family business, the family members should consider these issues, and procedures for buying out family members, even before anyone actually expresses an interest in being bought out. The goal should be to find an outlet for those shareholders who are not fully committed to ownership. In the long run, the business will be better for it.

C. There are any number of approaches that can be used to develop a plan for purchasing the stock of family members. Below are a variety of factors and approaches to consider.

1. Create a committee of family members to consider approaches and alternatives. Ideally, the committee should include both insiders (family members working at the company) and outsiders (those who do not). The Smith family should have one of Jayne's children, or Jayne if she is sympathetic, on the committee.

2. Will a family member who sells be allowed to share in less tangible benefits of ownership? For example, do all family members currently get health insurance through the company? Do they get discounts on or free samples of the company product? If Smith Metals holds its shareholder meetings at resort locations and reimburses family members for travel and hotel, will a selling family member still receive those benefits?

3. Should there be a set policy for periodically offering to repurchase stock? Should partial redemptions be allowed, or should it be an all or nothing decision for a shareholder who wants to sell?

4. Education is a key element to the process. If the company is going to insist on valuation discounts in purchasing individual family members' interests (as it rightfully should), then consider bringing in a business appraiser to educate family members at a family meeting. If payments would be made over time, using notes, provide information on the tax consequences of using notes. If partial redemptions will be allowed, provide information on the tax consequences.

5. The family members who are running the business should make full and complete disclosure of all financial information relevant to an individual family member's decision to sell. The company should consider offering to pay for an investment banker or business advisor to provide advice to family members who are considering a sale, so they are ensured of receiving professional advice on the terms of the transaction.

D. Redemptions of Stock.

1. A redemption of a shareholder's stock by the business is a very effective way to terminate or reduce the shareholder's interest in the business and provide him or her with liquidity. The business itself is often in the best position to fund a buy-out of a shareholder. Provisions for redemption of stock are often found in buy-sell agreements, and are frequently privately negotiated when a shareholder wishes to liquidate his or her investment.

2. A major problem in planning for redemptions (at least with respect to C corporations) is that the corporation purchases the stock of a shareholder, pursuant to a buy-sell agreement or otherwise, the proceeds paid to the shareholder will be treated as dividend income, rather than proceeds from a sale unless the redemption qualifies as an exchange under Section 302 or 303 of the Code.

   a. The difference between dividend and capital gain treatment currently is muted by the identical tax rates that apply. If the law changes back to taxing dividends as ordinary income, then the difference is important.

   b. Even now, dividend treatment means the selling shareholder receives no benefit from his or her basis in the stock.

   c. The difference in treatment also is critical if the stock is being purchased for a note. If the redemption is treated as a dividend, 100% the proceeds are taxed in the year of the sale, regardless of how the payments are structured.

3. A redemption will qualify for exchange treatment only if the redemption: (a) is "substantially disproportionate," (b) results in a "complete termination of the shareholder's interest, (c) is not "essentially equivalent to a dividend" in light of all relevant facts and circumstances, or (d) is necessary to pay estate taxes resulting from inclusion of the closely held stock in the shareholder's estate.

E. Substantially Disproportionate Redemptions. A redemption will be considered substantially disproportionate if:

- The individual has reduced his percentage ownership of the voting stock of the corporation by more than 20 percent;
- The individual has reduced his percentage ownership of the common stock of the corporation by more than 20 percent; and
- The individual owns less than 50 percent of the voting power of the corporation after the redemption.

EXAMPLE: Unrelated individuals A and B each own 50 of the 100 outstanding shares of XYZ common stock, and no other stock is outstanding. The corporation distributes $30,000 to A in exchange for 20 of his shares. This redemption would qualify as an exchange because A reduced his ownership in the common (and voting) stock by more than 20 percent. He owned 50 percent of the stock before the redemption (50 shares out of 100 shares) and 37.5 percent of the stock after the redemption (30 shares out of 80 shares). Since his 37.5 percent ownership is only 75 percent of his previous 50 percent ownership, he has had a reduction of over 20 percent, as is required. Since after the redemption he owns less than 50 percent of the stock, the redemption is substantially disproportionate.

1. These required reductions in ownership would often be easy to meet, were it not for the attribution rules that are applied in determining ownership of a corporation. IRC § 318.

2. The attribution rules provide that an individual is considered to own not only the stock he owns outright but also the stock owned by certain related parties. Specifically, the following stock will be attributed to the individual:

   - Stock owned by members of his immediate family (spouse, children, grandchildren, and parents);

   - Stock owned by certain entities (estates or trusts in which he is a beneficiary, partnerships in which he is a partner, and corporations in which he is a 50 percent shareholder); and

   - Stock that he has an option to acquire.

3. In addition, entities are considered to own stock owned by their beneficiaries, partners, and shareholders (if the shareholder is a 50 percent owner of the corporation).

4. These attribution rules can be applied more than once and become very complicated. Redemptions in family-owned corporations therefore often do not qualify under the substantially disproportionate rules. In the example above, were the two shareholders father and son the redemption would not have been substantially disproportionate since, after the attribution rules were applied, A would have been considered to own 100 percent of the stock both before and after the redemption. The attribution rules mean that Jayne's two children almost certainly would not qualify for a substantially disproportionate redemption.

F. <u>Complete Terminations</u>. To enable redemptions in family-held corporations to qualify for exchange treatment, Code Section 302(b)(3) was enacted. Section 302(b)(3) extends exchange treatment to a redemption in which the entire interest of a shareholder in the corporation (as shareholder, employee, director, or any other relationship except that of creditor) is terminated after the redemption. (Since the individual is entitled to retain his interest in the corporation as a creditor, the corporation is able to pay part of the redemption proceeds in the form of a note).

1. The individual must not only terminate his entire interest in the corporation, but must also sign an agreement whereby he recognizes that exchange treatment will subsequently be denied if he reacquires any interest in a prohibited capacity within ten years. In addition, special problems arise if the redeeming party received stock from or transferred stock to a related party during the ten-year period immediately before the redemption.

2. If the requirements of Section 302(b)(3) are met, the family attribution rules are waived. IRC § 302(c)(2). Thus, the individual whose stock is redeemed will not be considered to own stock that is owned by his spouse, children, grandchildren, or parents.

3. This type of redemption is useful in providing liquidity to an individual; however, it is much less useful if an estate or trust is to be the redeeming entity. This is because only *family* attribution is waived, not the attribution to the estate or trust of stock owned by a beneficiary. Thus, if any beneficiary of the estate continues to own stock in the closely held corporation (as would normally be the case in a family situation), the redemption will not qualify for exchange treatment under this provision.

4. On the other hand, a complete termination of an estate or trust may be effective if a family member of a beneficiary (rather than the beneficiary himself) continues to own stock in the corporation. Under applicable law, an estate or trust may waive family attribution from a family member of a beneficiary to the beneficiary if certain requirements are met. Specifically, both the estate or trust and the beneficiary must meet all the requirements for waiver, discussed previously. The beneficiary must also agree to be jointly and severally liable for any additional tax assessed in the event he acquires any interest in the company in a prohibited capacity within ten years.

5. The applicable legislative history emphasizes that this provision does not apply to waiver of attribution from a beneficiary to the estate or trust. Thus, in planning for the estate, one should assume that no complete termination of interest can be effected by an estate or trust if any of its beneficiaries continues to own stock in the corporation.

   EXAMPLE: XYZ Corporation redeems all the stock held in a trust of which an individual and his descendants are exclusive beneficiaries. The individual's father owns all the remaining stock of XYZ Corp. All the father's shares are attributed to the individual under the family attribution rules, and all the shares deemed constructively owned by the individual are, in turn, attributed to the trust under the entity attribution rules. If both the trustee and the individual sign the required waiver agreement and the individual agrees to be personally liable for any tax deficiency resulting from a prohibited reacquisition, then the family attribution rules may be waived and XYZ Corp.'s redemption from the trust will be a complete termination of the trust's stock interest. On the other hand, if the individual or any of his descendants also directly own shares of stock in XYZ Corp., those shares will be attributed to the trust under the entity attribution rules for which no waiver is permitted, and the trustee's interest in XYZ Corp. cannot be considered completely terminated.

6. For the Smith family, to accomplish a complete redemption of Jayne's children that will be treated as a sale, it may be necessary to first sever the family generation-skipping trust to separate out the interests of Jayne's children. They also may need to disclaim any contingent interests in the trust for the remaining Smith G3s that they would receive if another G3 died prematurely.

7. Where multiple family trusts are involved, it is necessary to undertake an extremely detailed and complex analysis to determine whether and how a family member's interest can be redeemed in a manner that will qualify as a complete termination.

G. <u>Redemption Not Essentially Equivalent to a Dividend</u>.

1. This determination must be made in light of all relevant facts and circumstances.

2. The case law and IRS pronouncements can be difficult to reconcile.

3. This provision will <u>not</u> apply if the redeemed shareholder, directly or by attribution, is deemed to own all of the shares of the corporation.

4. This provision is more readily available if the redeemed shareholder does not control the corporation.

H. Redemptions in S corporations

1. The foregoing discussion focuses on C corporations. The tax treatment of a redemption also matters in an S corporation.

2. A redemption that is a complete termination of the shareholder's interest will require the company to adjust its accumulated adjusted account ("aaa") by an amount that bears the same ratio the aaa balance as the number of shares redeemed bears to the total number of shares outstanding before the redemption. See IRC § 1368(e)(1)(B).

3. If the redemption is not treated as a sale, then the company's aaa is reduced dollar-for-dollar by the amount of money distributed to the redeeming shareholder. This can disadvantage the non-redeeming shareholders in the future.