# Business Succession Planning

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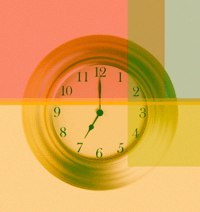
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# Introduction



Business succession is inevitable. Ultimately, a business owner must face the reality that he or she will not be able to lead the business forever. Thus, the business owner is faced with one of two possibilities: either a carefully planned and calculated process that is crafted to meet specific criteria or a rushed and often short-sighted procedure to address an unplanned departure. In this course, we explore the first approach of anticipating the owner’s departure by engaging in ***Business Succession Planning***.

To avoid confusion, it is important from the outset to distinguish Business Succession Planning from Business Continuation Planning. **Business** ***Succession Planning is done more from the perspective of the owner.*** It prepares the company’s employees, its owner, and the owner’s family for the day when the owner no longer participates in the business—a process that involves determining objectives, making decisions regarding the future leadership of the business, planning for taxes, asset protection, and the business owner’s estate.

***In contrast, Business Continuation Planning*** ***is conducted more from the point of view of the business.*** It seeks to address the steps a company must take to avoid being crippled by risk-related events, such as natural disasters, fire, or the loss of an owner or key employee.

Considerations and solutions that address Business Succession Planning and Business Continuation Planning do overlap. However, there are issues involved with Business Continuation Planning that are best left as the subject for another course. This course, while occasionally alluding to Business Continuation Planning, will maintain the perspective of the owner and the owner’s desire to identify a successor, prepare that successor, and identify the manner in which the transfer of ownership shall take place.

### Objectives:

By studying this course, the learner should gain an understanding of:

* The need for and parties to the succession planning process
* How different business structures impact the available succession options
* The primary succession concerns of the business owner
* The options available for transferring a business interest and considerations for each
* Planning for retirement income
* Estate considerations associated with various transfer techniques

# The Need for Succession Planning

An important step toward succession planning is the development of future leadership as well as systems, policies and procedures that will make a transition of ownership as seamless as possible. While a large Fortune 500 company may have the resources and experienced management team to maintain a diversified infrastructure of experience and expertise, the small company often relies more heavily on the capabilities of its owner(s). Thus, when considering a small company’s succession plan, the owner(s) must understand that the life of the business is at stake.

The following table shows the reasons businesses fail as identified by ROC Systems Pty Ltd., a company that helps accounting firms advise their clients in achieving specific goals.

|  |  |
| --- | --- |
| **Percent** | **Reason Businesses Fail** |
| 32.1% | Poor management of financial activities |
| 14.6% | Lack of management competence or experience |
| 12.4% | Inflation and economic conditions |
| 12.3% | Poor books and records |
| 10.7% | Sales and Marketing problems |
| 9.0% | Staffing problems |
| 6.2 % | Union problems |
| 2.7% | Failure to use external advice |

While “lack of a succession plan” does not appear on this list, there must be some reason why so many failures occur in the second generation of ownership. Notice, only 18.6 percent of failures—economic conditions and union problems—are outside of the owner’s control. This fact highlights how important it is for strong leadership to be in place to succeed an outgoing owner, and for the transition to be as smooth for all parties as possible. This is achieved through proper succession planning.

**Example**

Consider, for example, a CEO of a closely held company who is notified that he or she is terminally ill. This news has a substantial impact on the CEO, the CEO’s family, and the business. Although the CEO may be currently able to work (as opposed to having a disability), the CEO may decide to go ahead and retire, well before the company expected.

Without proper pre-planning, the company may be forced to make a substantial cash payout to buy the retiree’s stock. If it cannot do so, then the CEO may be without adequate means to retire. Furthermore, there is the question of the successor’s identity, the loss of productivity as management’s focus shifts from running a successful business to finding new leadership, and further productivity loss while new leadership develops the ability to keep the business on track.

With a succession plan, there are buy-sell agreements in place that deal with emergency situations like this one. Such agreements not only identify successor owners, but should also address all contingencies of a buy-out, including funding. In addition, there is limited interruption in management of the company because the successor is already identified. Such a plan can save the company critical financial resources, or may save the company altogether.

# Considering All Interests

**Business Owner**

**Family Members (in the business and not in the business)**

**Employees (key employees and general employees)**

It is important that a business succession plan integrate the interests of all those involved; however, ensuring that a succession plan addresses the needs of the business, its owner, its employees, and the family is often difficult because these interests are often in conflict with one another. For this reason, succession planning is a delicate process that must balance sometimes very disparate needs.

To develop a succession plan, the owner(s) should include in the planning process key employees, all business owners, and professional advisors who specialize in business succession. Key professionals who are often involved include: the attorney, financial planner, trust officer, insurance agent, company banker, and CPA. These professionals will help develop and control the transition process from beginning to end.

Beyond the interests of other individuals, it is also important to consider the business structure itself, because there are unique transfer considerations involved for each type of business structure. On the following pages, we will briefly examine the following business structures, discussing some of the implications of each:

* Sole Proprietorships
* C Corporations
* S Corporations
* Professional Corporations
* Partnerships and Limited Liability Companies

Discussion of actual techniques for making transfers involving these business entities will occur later in this course.

# Sole Proprietorships

In a ***Sole Proprietorship***, there is no separate business entity for tax purposes. All assets used by the proprietor for the business are actually owned personally by the proprietor. All liabilities incurred in the operation of the business are concurrently incurred by the owner and his or her personal assets are exposed to the risk.

Considerations regarding transfers of Sole Proprietorships include the following: **Click each link to learn more.**

Lifetime Sale

In a lifetime sale of the business, the transfer would include the specific assets used by the business and possibly some additional transfer of value attributable to intangible assets such as goodwill, reputation, a franchise agreement, territorial rights etc.

Partial Transfers

Partial transfers, e.g., gifts valued within the annual gift tax exclusion limits, are difficult to accomplish with a sole proprietorship because there are no shares of stock providing for easy transition of incremental ownership rights. If this was deemed beneficial, the proprietor would likely change the business structure to a corporation, an LLC, or possibly a partnership.

Transfers upon Disability or Retirement

In the event of the owner’s departure due to long-term disability or retirement, transfer of the business interest is generally best preplanned with a party who is active in the business or familiar with the business operations and marketplace.

If the business is sold, the proceeds may or may not be sufficient to provide for the departing owner’s future income needs. Ultimately, if the departing owner cannot forgo the income previously received from business operations, the best course of action is a previously established succession plan that makes use of life and disability insurance, as well as funding a retirement plan. In this manner, the future income needs of the disabled/retired owner can be funded with business dollars. Having such plans in place may also free up the possibility for gifting the business to family members, if desired, since the owner will not be dependent upon sales proceeds to provide funding for retirement income.

Transfers at Death

In the event of death, it can be critical that preplanning has been done. If there are any employees, they have no authority to continue business operations following the death of the proprietor. While the executor or administrator will have legal ownership of the business, he or she may have no ability or interest in running the company, or may be uncomfortable with assuming the liability to the estate of the deceased associated with continuing its operation. The alternative is to sell the business post-mortem, but the value tends to drop rapidly without an owner to run it. Relationships with customers and vendors can also be adversely affected.

If a preplanned and funded buy-sell agreement has been worked out with successors, especially if the survivors are active in the business, this transition can work well for all parties. In this case, dependent heirs, such as a spouse, will receive cash in exchange for the business interest and the new owners will receive assets with a higher tax basis, as well as a seamless transition of operations.

# C Corporations



With a ***C Corporation,*** ownership is broken up into small units of shares of stock. This makes it much easier to make partial or incremental transfers of ownership.

Profits of a C Corporation are taxed separately from its owners under subchapter C of the Internal Revenue Code. This results in double taxation of dividends, as no deduction is allowed for the corporation when it makes distribution of dividends. Thus, the corporation pays tax on the income that is used to pay the dividends, and shareholders are taxed on their receipt of dividends. In contrast, compensation to employees is deductible by the corporation; thus, compensation is only taxed once.

This different tax treatment between dividends and compensation can sometimes create conflicts of interest among shareholders of a closely held company. Shareholders who are actively involved in the corporation may receive income through compensation for their services, which avoids double taxation. Their preference may be to declare no dividends, thus avoiding double taxation and accumulating capital in the business for expansion/business needs. Caveat - C Corporation capital accumulations in excess of IRS limits may incur an accumulated earnings tax. Inactive shareholders, however, receive no income unless dividends are declared, and their desire for dividend income may be in conflict with the active shareholders. Such conflicts can be particularly acute when involving family members.

# S Corporations

In many ways, business succession planning for an ***S Corporation*** is similar to succession planning for closely held C Corporations. Unlike a C Corporation, however, with an S Corporation the company does not pay any taxes. That is to say, all profits “pass through” to the shareholders who are then taxed only at the individual level, rather than also at the corporate level.

Thus, any transfers of shares will carry with them a proportionate share in company profits. This may be particularly attractive where an owner is trying to transfer income to family members. However, this technique can also be onerous to the business since shareholders may be receiving profits without contributing to the success of the company.

# Professional Corporations



A ***Professional Corporation*** ***(PC)*** is a corporation that is limited to professional services, such as those of a doctor, dentist, or lawyer. It presents a unique problem in transferring ownership since a shareholder in a PC must by state law typically be held only by a licensed member of the profession.

# If the PC is deemed to have value beyond the skills of the practicing professional, it may be critical to work out a buy-out and succession plan prior to the departure, retirement, disability or death of the PC owner in order for the professional owner or heirs to realize the full value of the ownership in the PC. This is typically easier to accomplish when the professional is in practice with a co-owner(s), since they are the best candidates to enter into a mutually beneficial buy-sell agreement. Otherwise, a solo practitioner will want to find an outside professional buyer who wants to absorb or continue the practice of the departing professional.

A ***buy-sell agreement*** is a formal agreement whereby one party agrees to “buy” and the other party agrees to “sell” an ownership interest in the company at an agreed upon price upon the occurrence of a triggering event (e.g., death, disability, or retirement).

# Tax issues regarding professional corporations can be quite complex. A PC can be organized as a C Corporation or an S Corporation, which we previously discussed. Certain PCs can also be classified as Personal Service Corporations (PSCs), which are C Corporations, but net earnings of the PSC are taxed at a flat rate of 35% vs. a graduated C Corporation rate.

***Personal Service Corporations*** are defined as corporations that provide services in the fields of health, law, engineering, architecture, accounting, actuarial science, performing arts, or consulting where substantially all of the services are performed by owner-employees.

Alternatively, professionals often operate as a Limited Liability Company, which we cover on the next page.Partnerships and Limited Liability Companies

Finally, we examine the transfer of an interest in a Partnership or Limited Liability Company (LLC). A Partnership gives a business a high degree of flexibility in structuring the ownership and distribution rights of its owners. A Partnership can be a: **Click each partnership type to learn more.**

General Partnership

In a ***General Partnership***, the partners are liable for all of the liabilities of the partnership. They also have full management control. This is also a “pass-through entity” for tax purposes – the partnership is not itself a taxable entity.

Limited Partnership

A ***Limited Partnership*** offers more protection from liability, as limited partners are liable for partnership debts only up to the amount of the partner’s capital contributions. A Limited Partnership still has one or more general partners, who are still liable for all partnership liabilities and have full management control of the business.

A Limited Partnership is also a “pass-through entity” for tax purposes – the Limited Partnership is not a separate taxable entity.

Limited Liability Company (LLC)

The characteristics of a ***Limited Liability Company (LLC)*** vary based on differences in state laws. The LLC is a legal entity that can be formed by drafting articles of organization and submitting them to an appropriate state agency. An LLC can be treated as a Corporation (any number of members), a Partnership (at least two members), and, in most states, as a Sole Proprietorship (one member) for federal income tax purposes. In all states, however, unlike a General Partnership, no partner is liable for the malpractice of any of the other partners. Thus, an LLC combines the limited liability of a corporation with the benefits of flexibility in tax treatment that is enjoyed by partnerships.

An owner has options for transferring ownership in a Partnership or LLC.

The following lists a couple of options: **Click each option to learn more.**

Selling or Liquidating an Interest

Similar to the C Corporation, the interest in the business can be sold or the departing partner/member can liquidate his or her interest back to the company, effectively resulting in a transfer of ownership to the remaining partners/members.

Alternatively, the departing partner(s)/member(s) can sell its assets to the successor(s). Often, after an asset sale, the sales proceeds are distributed to the successor owner(s) in complete liquidation of the partnership.

Compensatory Transfers

An owner can transfer an unrestricted partnership interest as a form of compensation for services rendered (i.e., a compensatory transfer). Since it is a form of compensation, it triggers immediate taxable income for the recipient equal to the fair market value of the interest received, reduced by the amount paid, if any. This compensation is deductible to the partnership or LLC.

# Review Exercise

1. S Corporation succession planning shares very few characteristics with C Corporation succession planning.
   * True

Incorrect. Succession planning for a C Corporation and an S Corporation is very similar. Pass through rules of S Corporations present the only major differences.

* + - False

Correct. Succession planning for a C Corporation and an S Corporation is very similar. Pass through rules and limitations on ownership associated with S Corporations present the only major differences.

1. Which of the following describes a General Partnership?
   * Limited liability

Incorrect. This describes a limited partnership or an LLC. Try again.

* + Limited partners have full management control

Incorrect. There are no limited partners in a general partnership. Try again.

* + - Responsible for any liabilities of the partnership

Correct.

* + None of the above

Incorrect. Try again.

1. Which of the following correctly describes the tax rules regarding transfers involving partnerships and LLCs?
   * The income and loss generated by the partnership are taxed at the partnership level, but cash flow is distributed to the partners each year.

Incorrect. The income and loss generated by the partnership are not taxed at the partnership level, but flow through to the partners each year. Try again.

* + Income and losses generated by the partnerships are taxed at the partnership level.

Incorrect. Income and losses pass through to individual owners. Try again.

* + - It is possible for multimember LLCs to be treated as partnerships for federal income tax purposes.

Correct!

1. If a business owner is operating as a sole proprietorship, it is especially important to establish a business succession plan well in advance of an intended or unintended departure for all of the following reasons EXCEPT:
   * If the retiring or disabled owner is dependent on the income produced by the business, a previously established succession plan can provide income or cash to the owner funded with business dollars.

Incorrect. This is a valid reason to establish a business succession plan.

* + In the event of death, it is critical that preplanning has been done. If there are any employees, they have no authority to continue business operations.

Incorrect. This is a valid reason for a sole proprietorship to establish a business succession plan.

* + In the event of death, the executor or administrator has legal ownership of the business, but may be uninterested in operating the business or unwilling to assume the liability of doing so.

Incorrect. This is a valid reason for a sole proprietorship to establish a business succession plan.

* + Transfer of the business interest is best preplanned with a party who is active in the business or familiar with the business operations and marketplace.

Incorrect. This is a valid reason for a sole proprietorship to establish a business succession plan.

* + - None of the above

Correct. All of the above are valid reasons for a sole proprietorship to establish a business succession plan well in advance of an intended or unintended departure.

1. Key professionals who are often involved include all of the following EXCEPT:
   * Attorney

Incorrect. Both the personal attorney of the owner and the company attorney, if different, are important members of the team.

* + Certified Public Accountant

Incorrect. Both the personal accountant of the owner and the company accountant, if different, are important members of the team.

* + Company Banker

Incorrect. The company banker may be a creditor of the business and thus has a vested interest in the future of the business. In addition, financing may be involved in a transfer strategy.

* + Insurance Agent

Incorrect. An insurance agent may offer valuable insights regarding insured solutions.

* + - None of the above

Correct. All of the above are likely to be key members of a business succession planning team.

# Meeting the Three Primary Concerns of the Transferring Owner

Having discussed different types of business structures, we now turn to how a succession plan can be utilized to meet the primary concern of the transferring owner. In general, the transferring owner is seeking to resolve three primary concerns:

1. Who shall I select and groom as my successor?
2. What mode of transfer (e.g., gift, buy-sell agreement, etc.) shall I use?
3. Will I have Sufficient Resources for Retirement?

On the following pages, we shall address each of these concerns. To some degree, the concerns are intertwined. For example, the selection of a successor (e.g., a family member or an outside buyer) will impact the options available as a mode of transfer. Estate planning issues may also be considered in choosing between possible modes of transfer. Nonetheless, we shall proceed by:

* First considering the choices available as a successor.
* Next, for each possible choice of successor, we shall examine available modes of transfer. Certain estate planning considerations will also be discussed as these transfer modes are considered.
* Finally, we will speak to the need for income following the transfer.

# Concern #1: “Who do I Select and Groom as My Successor?”

A primary issue for consideration in business succession planning is the selection and grooming of a potential successor(s). Questions to be answered include:

* Who will ultimately be responsible for leading the business?
* Will there be more than one leader?
* How will the owner transfer business or industry-specific knowledge over to the new leadership?

From a group of potential candidates, the owner(s) must assess the candidates’ skills, experience, and leadership abilities against those required by the business.

# The process does not stop with simply identifying the successor. One of the most critical aspects of the succession process is making sure that the successor is ready to take control of the company when called upon to do so. Many of the reasons for business failure that were previously listed are a direct result of the successor not being properly trained to manage the business. Thus, the potential successor should be equipped with knowledge of the company’s financials and operations, as well as the policies and procedures that have been established to make the business operate efficiently.

# Options for Transfer of a Business Interest

# The importance and difficulty of selecting and grooming a qualified successor demonstrates why a successor owner of a small business is usually a family member active in the business, an outside party who owns a very similar or complementary business, a business partner, or key employee(s). Thus, the succession plan will generally involve the transfer of leadership and ownership of the business to one or more of these parties. Additionally, if the company is large enough, it may be offered for public sale. If no suitable choice exists among these, then there is always the option of closing the business.

In the end, whatever legal, funding, and managerial options are chosen, only six transfer options exist:

### Transfer Options:

1. Gift, bequeath or sell the business to the family
2. Sell to a third party
3. Sell to co-owners
4. Sell to employees
5. Take the company public
6. Close the business
7. Close the business

# Concern #2: “What Mode of Transfer Shall I Use?”

Once a successor is selected, the next issue to address is the mode of transfer to be utilized. To some degree, the options to be used will differ depending upon the identity of the successor. On the following pages, we shall examine each of the six transfer options listed on the previous page and explore possible transfer techniques and considerations associated with each.

***Keep in mind, as we discuss each option, that the association of techniques with each option is somewhat subjective.*** Many techniques can be used with multiple options. For example, while we will associate gifting techniques with transfers to family members, there is nothing that restricts gifts of business interests to those outside the family. However, to avoid duplication and unduly extending the length of this course, we have attempted to introduce the techniques and associate them where they are likely, but not exclusively, to be utilized.

# Option One: Transferring the Business to the Family

A business owner who wishes to transfer a business interest to members of his or her family must consider a wide range of issues that are unique to intra-family transfers. These issues might ultimately affect the specific transfer techniques that will be utilized to accomplish the specific objectives of an owner. Issues that are specific to family transfers include:

* Are there any family members actively working in the business or who might desire to work in the business in the future?
* What constitutes an equitable inheritance to family members, some of whom may be in the business and some may not?
* What steps are being taken to prepare a family member(s) for management of the business and on what terms would an ownership transfer occur?

These questions illustrate the fact that it is important, when assisting a client, to be able to quickly identify, amidst a wide variety of relevant issues, realistic options that may meet a client’s goals in transferring the business to the family, while also taking into consideration the limitations of the client’s resources.

On the following pages, we shall examine transfers to family members, first examining sales techniques, then gifting techniques, and finally addressing testamentary transfers.

# Sale to Family Member(s)

Why would a business owner want to transfer a business interest by sale during his or her lifetime versus waiting to bequeath the interest in a will or trust?

**Reasons for a Lifetime Sale to Family Members:**

1. The older generation owner may wish to retire.
2. The sale of a business interest provides funding for retirement income.
3. Health issues may force the owner to retire.
4. Younger family members may be ready to take over reins of the business and believe they merit ownership.
5. The older generation owner may wish to reward the efforts of younger generation family member(s) who are working in the business.
6. The older generation owner can cause resentment if contributing less but still making substantial withdrawals from the business.
7. Lifetime transfer is one method to alleviate publicity and the cost of probate.
8. Lifetime transfers can reduce transfer taxes at death of the older generation owner if sales proceeds grow more slowly than business value, are spent, and/or are gifted.

# Modes of Sale to Family Members

If the decision is made to sell a business interest to family members, a combination of transfer and/or funding techniques may be utilized to suit the financial circumstances and objectives of the family members in any particular situation. Some of these techniques are listed below. Click each technique to learn more.

Buy-Sell Agreement

A ***Buy-Sell Agreement*** is a formal agreement whereby one party agrees to “buy” and the other party agrees to “sell” an ownership interest in the company at an agreed upon price upon the occurrence of a triggering event (e.g., death, disability, or retirement). Entering into a Buy-Sell Agreement can be particularly appealing as a means of facilitating an intra-family sale if those involved in the agreement are active shareholders/partners.

If the Agreement is structured such that the business entity is to purchase the outgoing owner’s interest in the business, the “family attribution rules” can come into play, which can cause the purchase payment to be taxed as dividends to the selling shareholder. For this reason, such Agreements, when involving family members, will generally be structured so that family members agree to purchase the shares directly from the existing owner at an agreed price with specified terms.

Typically, the main obstacle to this type of purchase is the ability of the buyer(s) to come up with the funds to purchase the company. They typically have six funding options: **Click each funding option to learn more.**

1. Cash

***Cash*** - The buyers have accumulated the necessary funds to make the purchase with cash.

1. Outside Financing

***Outside Financing*** – Each buyer borrows the money from a lender, such as a bank, possibly using the stock as collateral. The seller receives cash and each buyer must make after-tax payments to the lender in accordance with the terms of the loan.

1. Life Insurance

***Life Insurance*** – Each buyer purchases life insurance on the seller in the amount of the purchase price. If permanent coverage is used and the policies are in force for several years, cash values could be used to assist in a lifetime buy-out and/or death proceeds used to ultimately repay a buy-out loan. Premiums could be paid by the buyer or a split-dollar plan could be arranged with the company to assist the buyer(s) with the cash outlay required by the premiums. Note that if the deceased owner’s interest is purchased from an heir, the heir realizes a stepped-up basis in the value of the business interest that he or she sells. In contrast, if an owner’s interest is purchased while they are living, the seller does not realize a stepped-up basis and may realize a capital gain.

1. Disability Buy-Out Insurance

***Disability Buy-Out Insurance*** – Each buyer purchases Disability Buy-Out Insurance on the seller. In the event of long-term disability of the seller, the buyers would receive insurance proceeds which they could use to purchase the seller’s stock. The buyer would need to have the resources to pay the premiums or possibly the company might bonus adequate funds to make the premium payments.

1. Installment Sale

***Installment Sale*** – An installment sale (which can be done with or without a buy-sell agreement) works just like a cash sale except that the payments are financed by the seller. This eases the burden of payments on the buyer and stretches out the tax liability to the seller. The seller has some risk of default.

Keep in mind that an installment sale removes the value of the potentially *appreciating value of the company* from the seller’s estate. The balance of the loan still receivable at the seller’s death, if any, would be in the seller’s estate, but any appreciation in the value of the company would be removed from his or her estate.

Self-Cancelling Installment Note (SCIN)

A ***Self-Cancelling Installment Note (SCIN)*** is an installment note that is specifically designed with a cancellation-at-death provision in the note. This has the benefit of relieving the family member buyer of making future payments if the seller dies before the loan is paid in full. Its further benefit is that, since the note has zero value at death, NO VALUE is included in the seller’s estate.

This type of note must be designed carefully to avoid falling into unintended tax traps. Due to the forgiveness feature in the event of premature death, the size of the note must be increased and/or the interest rate must be increased over market rates to reflect the increased risk of limited repayment to the seller/creditor. **Click here to read a case study involving a SCIN.**

### Case Study – SCIN

Mr. Smith (the seller) is 65 years old and wishes to transfer to his children an interest in the family business that has a current fair market value of $1,000,000 and a cost basis of $100,000. [Note: in computing the fair market value of the business interest, one must consider the discount for lack of control and discount for lack of marketability to determine if each are appropriate. If either is appropriate, such discount will be passed along to the buyer.]

If Mr. Smith sells the interest in the business outright to his children, he would report a $900,000 capital gain on the sale of the interest in the family business. This capital gain may receive favorable tax treatment for federal income tax purposes (most likely at the 20% tax rate, but AMT and state taxes may apply), which in this case would mean a federal tax liability of $180,000 (assuming there is neither depreciation recapture nor any other ordinary income assets; otherwise, the tax rates could be 25% to 39.6%). After taxes, Mr. Smith would net $720,000.

Instead, Mr. Smith decides to use a SCIN with a 10-year, self-amortizing installment note at a 5% minimum annual interest rate (determined by the IRS) and a $100,000 down payment from his children. To adjust for the self-cancelling feature, either the price or the interest rate must be adjusted. If the purchase price premium method is used, the purchase price must be increased from $1,000,000 to approximately $1,528,300, with annual payments of $114,600 per year to account for the cancellation provision of the note. If the interest rate premium method is used, then the annual interest rate would be increased from the 5% minimum to at least 12.5% (a spread of 7.5% also determined by the IRS), with annual payments of $124,900 per year.

The key component of the SCIN is the term of the installment note. The term must be less than Mr. Smith’s remaining life expectancy in order to avoid private annuity treatment. If Mr. Smith dies before the term of the note, then the children may have paid far less than fair market value and the asset will have transferred to them with no estate or gift taxes. If Mr. Smith lives beyond the term of the note, then the terms of the note will have been met in full; however, Mr. Smith’s children will have paid more than the fair market value of family business interest.

Private Annuity

A ***Private Annuity*** is very similar to an installment sale except the payments are calculated differently. For example, if we assume Joe, Jr. is purchasing Widgets, Inc. from Joe, Sr. for $1,000,000, Joe, Jr. would make a fixed payment to Joe, Sr. for as long as Joe, Sr. lives. The amount of the payment is determined by IRS prescribed market interest rates at the time of the sale and Joe, Sr.’s life expectancy. If Joe, Sr. dies before the full $1,000,000 plus interest is recovered, Joe, Jr. has effectively received a discount. If Joe, Sr. lives longer than the prescribed life expectancy Joe, Sr. receives a premium for the sale of the business.

One primary advantage of this approach, unlike an installment loan, is that none of the business value is included in Joe, Sr.’s estate regardless of when he dies. Another advantage may be that Joe, Sr. receives a retirement income that he cannot outlive (as long as Joe, Jr. is able to make the payments).

Caution is warranted if the annuity is purchased with non-cash assets, such as appreciated securities. Under current law, all of the capital gain imbedded in the appreciated securities is recognized for income tax purposes immediately in the year the annuity is purchased. This caution does not apply to Private Annuities purchased for cash.

Asset Sale

**Sole Proprietorship** – From a tax standpoint, the sale of a sole proprietorship is actually a sale of specified assets. All of the previously listed funding methods could be utilized. The only likely difference is the tax ramifications. The seller may incur some ordinary income tax liability upon sale of the business, but most of the gain, if any, will be taxed at capital gain rates.

**Partnerships** -Partnership tax issues in the event of a lifetime or after death sale are more complex and beyond the scope of this course, but are similar to those of a sole proprietor.

**Corporation** – In some situations, the younger family members may want to purchase certain assets of the business prior to or in concert with a plan to purchase the company stock. For example, a son in the business may wish to purchase real estate, equipment, etc., from the corporation and lease it to the business or possibly to another entity. This type of purchase could provide the buyer with tax-advantaged cash flow and possibly remove an appreciating asset from the business.

Bargain Sale

A ***bargain sale*** is a sale of property for less than full fair market value. The consideration received by the seller represents the sale, and the excess value transferred is considered a gift. For example, a business owner may wish to transfer a $1,000,000 business to an adult child, but needs income to provide support during retirement. Rather than selling for $1,000,000, the owner might sell for $400,000, making a gift of the balance.

# Lifetime Gifts to Family Members

One of the unique characteristics of transfers to family members is the possible desire to make the transfers as gifts rather than sales. Lifetime gifts of a business interest differ from a sale in two primary ways:

1. The donor does not receive any cash or compensation for the gift, thus providing no funds to produce income for the owner or to fund any personal objectives or needs. In fact, gifts may actually cause a cash outflow if a gift tax is incurred, since the donor is responsible for filing a gift tax return and paying any tax due.
2. Gifts reduce the size of the donor’s estate by the amount of the gift plus any appreciation that the business interest may realize after the gift is made.

There are two key gift tax exclusions available to facilitate transfers through gifts. **Click each exclusion to learn more.**

Annual Gift Tax Exclusion

Gifts to any person within the ***annual exclusion*** ($14,000 in 2016 , as indexed) are excluded from gift taxation. A husband and wife can “split gifts”, thereby combining their annual exclusions to gift up to twice the annual exclusion amount ($28,000 in 2016 , as indexed), regardless of which spouse actually provides the funds. The only requirement is that the gift be of a “present interest,” meaning the donee must take receipt of the gift and the benefits of ownership.

As noted earlier, gifting small increments of a sole proprietorship, partnership or an LLC can be difficult. Gifting of a sole proprietorship interest involves specific assets of varying values, and partnerships require approval of other partners or members. Gifting of corporate stock is much simpler.

Annually gifting small portions of stock (covered by the annual gift tax exclusion) can add up to substantial amounts over time. In addition to reducing the size of the donor’s estate by the value of the stock at the time of transfer, any ***growth*** in business value is transferred out of the estate of the donor as well, thus possibly reducing transfer taxes. For example, if a husband and wife joined in making transfers of stock to two children over 10 years, this would result in $560,000 of gifts. In addition, if the stock’s value appreciated at 6% per year, at the end of ten years, the donor would have removed more than $700,000 of asset value from his or her estate.

Lifetime Gift Tax Exclusion

An individual can also make gifts in excess of the annual exclusion that are subject to gift tax. However, there is a cumulative lifetime gift tax credit available to each taxpayer that totals $2,125,800 (in 2016, as indexed), which is equivalent to an exclusion of $5,450,000 of gifted assets (in 2016, as indexed). For example, a married couple could join together in making a tax-free gift of a $10,900,000 business interest (plus additional annual exclusion gifts), assuming neither spouse had made prior taxable gifts.

Note again that not only would the size of the donor’s estate be reduced by the value of the gifted business interest, any ***growth*** in business value is transferred out of the estate of the donor as well.

One disadvantage of making gifts during life, rather than waiting to transfer assets at death, is that the tax basis of gifted shares would be the basis of the donor. In contrast, if the shares are transferred at death, the basis is stepped up to the current fair market value as of death (or 6 months later, if the executor so elects).

Note that when making gifts, the donor will need to establish a credible value of the business interest being transferred. These valuations or appraisals will likely result in extra costs to the donor. The valuations, however, may allow for discounted values due to the limited marketability of a closely held company and/or due to the gifted shares representing a minority interest.

Also, note that gifts of an interest in a pass-through entity, such as an S Corporation, will result not only in transfer of ownership rights but also in transfer of profits (or losses) to the donee. This may not be the case with transfers of shares in a C Corporation, since a C Corporation may or may not choose to pay dividends (at the discretion of the majority owners).

# Family Limited Partnerships (FLPs)

***A Family Limited Partnership (FLP)*** is a limited partnership formed to hold the family business or investments, with the idea that the parents will make gifts of their limited partnership interests to their children. FLPs have been used by business owners and tax planners for many years as a technique to transfer ownership interests to family members.

One of the benefits of FLPs is that they simplify gifting of property interests to family members. Clients often own assets, such as real estate or a business, that can be difficult to divide among children and other potential beneficiaries. Giving fractional interests in the property may be legally possible, but not practical if the client wants to keep the property ownership intact within the family. Gifting partnership interests to family members is much easier and provides other significant benefits as well.

**Click each additional benefit to learn more.**

Maintaining Control

Older generation family members can gift interests in the FLP while still maintaining control.

Protecting Against Creditors

A creditor of a limited partner generally cannot reach the assets of the partnership or compel the partnership to issue distributions.

Taking Advantage of Economies and Diversification Opportunities

An FLP is a convenient way to consolidate assets into larger blocks that might qualify for some of the benefits available to larger portfolios and provide greater opportunities for diversification.

Keeping the Interests within the Family

With appropriate buy-sell agreements, an FLP can be used to keep control of assets or a business within a family. For example, such arrangements may provide protection from dilution of the family’s interest in the company due to divorce settlements.

Valuation Discounts

When an FLP is structured so that one partner holds all the voting interest and the other partners hold non-voting interest, valuation discounts can be obtained for the non-voting interests due to their lack of control and reduced marketability. This will be illustrated in a subsequent case-study.

# Disadvantages of Family Limited Partnerships

While FLPs offer many advantages, the client should be aware of the possible disadvantages, including: **Click each disadvantage to learn more.**

Administration Expenses

Setting up and maintaining an FLP requires administrative expenses such as legal fees for drafting the partnership agreement and transferring legal title to assets, filing fees, valuation costs, and preparing and filing gift tax returns and partnership income tax returns.

Potential IRS Scrutiny

The audit division of the IRS has specifically targeted the valuation of “fractured entities,” such as FLPs, for increased scrutiny.

Potential Family Disharmony

If family members cannot agree on fundamental financial objectives, FLPs can cause more family problems than they solve.

Liquidity Concerns

Once ownership interests are transferred to other partners, it may be difficult for the contributing partner to take distributions of cash without making distributions to all partners.

Potential Legislation

The U.S. Treasury Department has made several attempts to enact legislation restricting valuation discounts for FLPs, and could meet with success in this endeavor in the future.

# Case Study – Family Limited Partnership

Mr. Smith is the owner of a business that has been valued at $3,000,000. In order to transfer the business to family members, Mr. Smith retains legal counsel to draft an FLP agreement. In this agreement, Mr. Smith retains possession of a 2% voting interest in the company while gifting a remaining 98% non-voting interest to family members. Since the gifted interests are non-voting, their value would likely be discounted due to lack of control and marketability. Suppose the control discount is 25% and the marketability discount is 30%. The resulting gift amounts would be computed as follows:

|  |  |
| --- | --- |
| Business Value (100%) | **$3,000,000** |
| Gifted Amount (98%) | 2,940,000 |
| Control Discount (25%) | (735,000) |
| Subtotal: | 2,205,000 |
| Marketability Discount (30%) | (661,500) |
| Gifted Amount After Discounts | **$1,543,500** |

Mr. Smith has reduced the amount of his gift from $3,000,000 to $1,543,500. He has substantially increased the remaining balance of his unified applicable tax exclusion for estate tax purposes. Additionally, his estate now only contains a 2% ownership interest in the business, but he still maintains full control since his interest is the only voting interest in the business.

# Recapitalization

***Recapitalization*** is also often done to facilitate a transfer of a C Corporation to family members. This is especially true when the family business owner wishes to 1) retain an income stream and/or 2) freeze his/her estate by transferring growth to the family successors.

A recapitalization involves rearranging the capital structure of the company. When the owner’s objectives include a need for income, typically almost all of the owner’s common shares of stock are exchanged for newly issued preferred stock, which pays a dividend, typically at a fixed rate as a percentage of the par value of the preferred stock. While the preferred stock will provide a relatively predictable and cumulative dividend, it has virtually no growth potential because the growth is retained in the outstanding common shares.

Typically, the owner transfers common shares to the successor family member(s), while retaining the preferred stocks. In this manner, the owner receives future income, but all business growth following the transfer is retained with the common stocks and thus accrues to the benefit of the successor owner(s). **Click here for an example of this technique.**

Peter Patriarch owns all of the outstanding stock of Patriarch Throne Co., Inc., which totals 1,000 shares of common stock. Patriarch Throne’s Board decides to recapitalize the corporation. It has been determined by professional valuation that the company is worth $10,000,000. The corporation issues 9,000 shares of new preferred stock with a par value of $1,000 per share and a cumulative dividend of $60.00 per year or a 6% yield (assumed current market rate). Peter exchanges 900 shares of his common stock worth $9,000,000 for 9,000 shares of the preferred stock worth $9,000,000.

Peter then gifts (or sells) his $1,000,000 of common stock to his son Paul, who is an officer of the company working in the business. (Employment or relationship of Paul is not necessary to make transaction work – we are assuming here that Peter wants to transfer ownership to his son who is actively involved in the business.)

Peter has accomplished three primary objectives:

1. Peter has transferred a business interest to his son at little or no cost to the son.
2. Peter has a relatively predictable income stream for retirement.
3. Peter has “frozen” the value of his business interest at $9,000,000 vs. allowing the value of the common stock to continue to increase the value of his estate.

# Note that recapitalizations can be very complex and must be designed very carefully to avoid unintended consequences. Your client will want to hire very experienced and competent counsel to consider and arrange such a transaction.Grantor Retained Annuity Trust (GRAT)

As illustrated in the Family Limited Partnership case study, discounted values can be quite useful in facilitating intra-family transfers. Another technique that can be helpful in making transfers at discounted gift tax valuations is a Grantor Retained Annuity Trust (GRAT). A **Grantor Retained Annuity Trust (GRAT)** is a technique where the grantor (donor) transfers property (or other assets) into an irrevocable trust which, in turn, will provide the grantor with a cash annuity payment for a pre-determined period of time. Once the annuity obligation to the grantor has been fulfilled, the beneficiaries of the trust will receive the balance that is remaining in the trust.

The key advantages of using a GRAT are:

1) A retained income flow,

2) Transfer of assets to beneficiaries at a reduced valuation, and

3) Transferring some or all of the appreciation out of the donor’s estate.

Here is how a GRAT works: **Click each numbered bullet sequentially to learn more.**

**Grantor**

**GRAT**

**Remainder**

**Beneficiary**

Example

1

The grantor gifts property to an irrevocable trust (meaning the grantor cannot change the trust once it is funded).

2

The grantor retains the right to receive an annuity from the trust for a period of years, with the “remainder” of the trust subsequently distributing to non-charitable beneficiaries (e.g., family members). The amount of the annuity payments is a percentage of the property as valued upon funding, and can be satisfied either through earnings on the assets, distributing assets back to the donor at current market values, or a combination of the two.

3

In funding the trust, the grantor makes a gift of the remainder interest that will ultimately pass to the remainder beneficiaries. Any gift tax due will be due upon funding.

The value of the gift (for gift tax purposes) is equal to the amount contributed to the trust minus the value of the annuity that is retained by the grantor. Thus, the value on which the gift tax is calculated is something less than the amount contributed. To calculate the value of the annuity, the IRS provides the discount rate to be used (the §7520 rate).

4

If the grantor lives beyond the period of the structured annuity, then the trust assets (including appreciation) will pass to the remainder beneficiaries free of additional estate or gift taxes. However, if the grantor dies before the termination of the structured annuity, then the grantor’s retained interest will cause the trust assets to be included in the grantor’s estate.

5

**Example**

Assume George wants to gift $500,000 of stock to a GRAT from which he wishes to receive an income of $50,000 per year for a duration of 5 years. At the end of five years, the remaining principal passes to George’s three children. If the IRC Section 7250 rate is 2%, then the present value of George’s retained annuity is $235,673. Thus, for gift tax purposes, the value of George’s gift to the trust is $500,000 - $235,673 = $264,327. Let’s further assume that the total return on the stock is 12% per year. At the end of the 5 years, net of the annual distributions back to George, the remainder beneficiaries will receive $563,528.

This is nota gift of present interest (the remainder beneficiaries do not presently receive anything), thus the annual gift tax exclusion is not available. George will have to rely on his lifetime gift tax exclusion (currently $5.45 million in 2016, as indexed) to avoid paying a gift tax.

# Intentionally Defective Grantor Trust (IDGT)

A final technique we shall consider for transfers to family members is an ***Intentionally Defective Grantor Trust (IDGT)***. Ordinarily, a ***Grantor Trust*** is one in which the grantor (the person creating the trust) is treated as the owner of the trust for both income tax purposes AND estate tax purposes. However, an Intentionally Defective Grantor Trust (IDGT) is an irrevocable trust in which the grantor is treated as the owner for income tax purposes but NOT as the owner for estate tax purposes. In other words, the grantor is taxed on all trust income, but the assets themselves are outside the grantor’s estate for estate tax purposes.

This provides a significant planning opportunity for individuals who want to reduce the size of their taxable estates while also transferring their business interest to family members. In a manner similar to a SCIN, the grantor creates the trust and sells the business interest to the trust in exchange for an installment note. The note should be for a predetermined period of time and can be self-amortizing or can be interest only with a balloon payment at the end of the term.

# Advantages and Disadvantages of an IDGT

Provided the note’s interest rate is not below market, the following benefits are achieved with an IDGT:

* No taxable gift is made in transferring the business interest, since the transfer is a sale rather than a gift.
* No capital gain is recognized upon the sale to the trust; nor is it recognized as the note is paid down. This is because, for income tax purposes, the grantor is still considered the owner of the asset.
* All future appreciation is removed from the grantor’s estate.
* When the grantor dies, only the fair market value of the note is in the grantor’s estate.

The main disadvantages are that:

* The fair market value of the loan balance will be included in the grantor’s estate (unlike the SCIN, where the unpaid balance of the loan is excluded from the grantors estate).
* The grantor continues to be taxed on all trust income, although the tax payments themselves may further serve the grantor’s objective of reducing the size of the grantor’s taxable estate.

The IDGT will be most successful if the assets are subject to discounts at the time of sale regarding their valuation, such as the discount for lack of control and the discount for lack of marketability. Another way to be more successful in using an IDGT is if the transferred assets appreciate at a rate higher than the interest rate on the installment note.

# Case Study – IDGT

To illustrate the use of an IDGT, let’s assume Mr. Smith (the seller) is 65 years old and wishes to transfer to his children an interest in the family business that has a current fair market value of $2,000,000 (after the discount for lack of marketability). Instead of selling the business interest directly to the children and taking back an installment note, Mr. Smith creates an intentionally defective grantor trust, naming the children as beneficiaries. He funds the trust with $300,000 of assets other than his business interest and files a gift tax return. Since every individual can make cumulative lifetime gifts of up to $5,250,000 (in 2013, as indexed) without gift taxation, we assume that he has a sufficient unused gift tax credit to avoid paying a gift tax on the $300,000 gift.

Next, Mr. Smith sells his business interest to the trust for the fair market value of $2 million. In return for the sale of the interest in the IDGT, Mr. Smith takes back a 10-year installment note at 7%. Since this is a sale, there is no gift tax on the transfer of the business interest. Trust income and, if needed, the other trust assets are used to pay off the note.

During the life of the installment note, the trust averages $300,000 per year of income. Annual payments to Mr. Smith are $284,755. Mr. Smith is taxed on all trust income, but does not pay tax (neither interest income nor capital gain) on the installment payments themselves because, for income tax purposes, he is still considered the owner of the asset (i.e., it is as if he is paying off a note to himself).

With growth of the business, let’s assume that the business interest is worth $6,000,000 at the end of ten years. Mr. Jones has effectively:

* Transferred his business interest to his children.
* Removed the $4,000,000 of appreciation on the business interest from his estate.
* Removed from his estate the income taxes paid on the $300,000 of annual trust income.

# Testamentary Transfers

While lifetime gifts make it possible to remove future appreciation from one’s estates, the fact remains that many, if not most, transfers to family members are made at death. While the estate executor can sell the business in a manner similar to those available to the business owner while alive, for our purposes we will confine this discussion of testamentary transfers to bequests to family members that are made without consideration (i.e., similar to gifts).

In making bequests to family members, there are a number of tax breaks that help make such transfers possible without transfer taxation. **Click each tax break to learn more.**

Unlimited Marital Deduction

Transfers of an unlimited amount, both during life and at death, can be made to spouses who are U.S. citizens without estate or gift taxes.

Applicable Exclusion Amount

For deaths occurring in 2016, a credit is provided against estate taxes that exclude the first $5,450,000 (as indexed) of assets from estate taxes. However, the availability of this exclusion to protect estate assets at death is reduced to the degree that the lifetime gift tax exclusion has been used in life. For example, if the lifetime gift tax exclusion were used to protect a $1,500,000 lifetime gift from gift taxes, then only $3,930,000 of estate assets at death would have been protected.

There are also tax breaks associated with paying the estate tax when the transfer of a family business occurs. **Click each tax break to learn more.**

Section 6166 Election to Pay Estate Tax in Installments

When a closely held business comprises more than 35% of the adjusted gross estate (or when businesses comprising more than 20% each are aggregated to over 35%), it may be possible to pay the estate tax on the business in installments. In fact, once the estate tax return is filed 9 months after death, the tax due on the business can be deferred for four years by paying interest only. Thereafter, the tax is paid in up to 10 annual installments (with interest). This can greatly facilitate transfers of a business to family members, allowing the tax to be paid over time and avoiding the need to sell the business at a fire sale if cash is needed to pay the tax.

Section 2032(A) Special Use Valuation

Real property is typically valued for estate tax purposes at its best and highest use. Sometimes, however, this derives valuations that are higher than would be derived by its current actual use. For example, the real property may be used as farmland or may be used in a business or trade in an area where higher prices can be achieved if the land is used for residential development. For such situations, Section 2032(A) may allow for a special use valuation that will reduce the estate tax liability associated with the property.

To qualify for the special use valuation:

* The real property must be located in the U.S.
* The decedent must have been a citizen or resident of the U.S. at the time of death.
* The property must have been used in a farming operation or business or trade, and actively managed by the decedent or a family member for at least five of the eight years prior to death.
* The adjusted value of the real or personal property associated with the farm, business, or trade must be 50% or more of the adjusted value of the gross estate (with the real property alone constituting more than 25%).
* The property must pass to a qualified heir (generally restricted to family members).

If, within ten years of the decedent’s death, the qualified heir disposes of any interest in the qualified property to anyone other than another family member or ceases to use the property for a qualified purpose (e.g., as a farm), then the tax savings may be subject to recapture.

Family Business and Section 303 Stock Redemptions

Stock redemptions involving a company owned by family members can be a tax minefield due to family attribution rules. Section 303 provides income and estate tax “assistance” to certain estates holding shares in a closely-held corporation. If the value of closely held stock exceeds 35% of the adjusted gross estate of the deceased stockholder, a stock redemption can take place between the estate and the corporation up to the amount of the estate transfer taxes, funeral, and estate administration expenses. For this exception, family attribution rules do NOT apply. Thus, the estate will typically incur no income taxes upon sale of the stock to the corporation due to recognition of the transaction as a sale of stock, the basis of which is stepped up to current market value at date of death (or six months later, if elected by the executor).

In addition, this exception can be utilized if the Section 6166 installment payment of estate taxes is elected. Thus, stock redemption between the estate and the corporation could take place over a number of years.

# Providing Equitable Inheritances to Non-Participating Family Members

A primary reason family business owners delay creation of a business succession plan is the difficulty of determining how to leave their estates to heirs when some of the family members are not actively involved in the business. Most owners (and successors) will agree that it is unfair for inactive family members to be given equal ownership and equal enjoyment of business profits when they are not actively contributing to its success. On the other hand, most owners (and inactive family members) would agree that it is unfair to transfer the business solely to the active family members without some type of equalization of their inheritance.

How then to resolve this dilemma? The following are possible solutions: **Click each solution to learn more.**

1. Sell the business to family members who are active in the business.

If the successors purchase the departing family member’s interest, they will provide payment to the owner or deceased owner’s estate. The selling owner can thus distribute the non-business assets to heirs as he or she deems equitable.

2. Fund an irrevocable life insurance trust.

The owner can establish a funded irrevocable life insurance trust to provide “extra” liquid funds for distribution to the family members who are not active in the business. In this manner, the owner can provide equalization in a manner he or she deems equitable.

3. Use other assets to make equitable transfers.

If the family business owner accumulates substantial assets comparable to the value of the business, these other assets can be distributed to family heirs in a manner deemed equitable by the family business owner.

# Review Exercise

1. All of the following are benefits of Family Limited Partnerships EXCEPT:
   * Older generation family members can gift interests in the FLP while still maintaining control

Incorrect. This is not the only benefit listed.

* + They simplify gifting property interests to family members

Incorrect. This is not the only benefit listed.

* + Protection against creditors

Incorrect. This is not the only benefit listed.

* + - Administration expenses minimal

Correct. Administration expenses, such as legal and filing fees, are a disadvantage of FLPs.

1. Which of the following utilizes an annuity?
   * + GRAT

Correct!

* + Self-cancelling installment note

Incorrect. Try again.

* + IDGT

Incorrect. Try again.

* + None of the above

Incorrect. Try again.

1. Which of the following statements is FALSE regarding Grantor Retained Annuity Trusts (GRATs)?
   * A grantor can transfer property into an irrevocable trust which will provide the grantor with a cash annuity payment for a specified number of years

Incorrect. This is a true statement. Try again.

* + Beneficiaries will generally receive any balance remaining after the grantor’s annuity obligation has been paid out by the trust.

Incorrect. This is a true statement. Try again.

* + - In funding the trust, the grantor makes a gift of present interest, which is eligible for the annual gift tax exclusion.

Correct! In funding the trust, the grantor makes a gift of a future interest that will ultimately pass to the remainder beneficiaries. Gifts of a future interest are NOT eligible for the annual gift tax exclusion.

* + All of the above are true statements

Incorrect. One of the above statements is false. Try again.

1. Which of the following statements about a self-cancelling installment note (SCIN) is FALSE?
   * A SCIN is an installment note with a provision allowing the unpaid portion of the note to be cancelled upon the exercise of the seller.

Incorrect. This is not the only false statement. Try again.

* + A SCIN will usually be structured so that the installment note is for a term longer than the life expectancy of the person selling the transferred assets.

Incorrect. This is not the only false statement. Try again.

* + The terms of the promissory note must include an interest rate discount or purchase price discount

Incorrect. This is not the only false statement. Try again.

* + None of the above statements are false

Incorrect. Try again.

* + - All of the above statements are false

Correct. These are all false statements.

1. An IDGT is revocable.
   * True

Incorrect. An Intentionally Defective Grantor Trust is irrevocable.

* + - False

Correct. An Intentionally Defective Grantor Trust is irrevocable.

# Option Two: Selling to a Third Party

Often, a closely-held family-owned business will be transferred to family members, but there are numerous reasons why that approach is not always appropriate. Possibly none of the family members are interested in the business or qualified to manage it. There may also be conflicting relationships among family members and/or between family members and key employees. When there is not a viable family successor, a fresh start for the company may be more desirable. To accomplish this, an owner might look to sell the business to another company or to a qualified outside individual.

Regardless of the reason, selling a business to an outside third party is a common method of transferring ownership in closely held businesses. It can be structured as an asset sale or a stock sale. The choice between these two methods involves different legal, tax, and accounting consequences to both the seller and the buyer. **Click each approach to learn more of implications of each type of sale.**

Stock sale

Sellers typically prefer stock sales. In a stock sale, both the assets AND liabilities of the business are transferred to the new ownership. In addition, in the event of a lifetime sale, sellers usually pay relatively low individual capital gains rates when selling company stock. If the sale occurs after the death of the shareholder, the estate of the deceased receives a stepped up basis in the stock and pays little, if any, capital gains tax.

Asset sale

Buyers typically prefer asset sales. In an asset sale, the buyer does not assume liability for actions taken by managers and employees before the transaction is completed. The buyer’s basis in the assets will also be the purchase price, which can be depreciated. This is much more favorable than a stock sale, where the buyer inherits the seller’s depreciated basis.

Asset sales are most likely to occur with sole proprietorships and partnerships. With a sole proprietorship, the seller is actually making an asset sale of the business. If a lifetime sale, the seller would possibly incur ordinary income and capital gains (or losses) from the sale of assets. If sold after the death of the owner, the estate of the deceased receives a stepped up basis in the stock and pays little, if any, capital gains tax. With partnerships, tax issues in the event of a lifetime or after-death sale are more complex and beyond the scope of this course, but are similar to those of a sole proprietor.

# Considerations When Selling to a Third Party

Here are some important items to consider when considering the sale of a closely held business to a third party: **Click each consideration to learn more.**

Evaluating the potential purchaser

Selling a business requires a lot of time and expense. Therefore, a seller should be sure the buyer is committed to running the business and has the resources to afford the purchase of the business before expending significant resources to negotiate the sale.

The purchaser should be able to clearly identify his or her objectives in making the purchase. Typically, purchasers are motivated by:

* The chance to operate the business
* The potential for significant financial return
* The opportunity to expand their market
* The opportunity to eliminate competition
* The opportunity to add expertise to the purchaser’s company

Whatever the motive, the seller should be comfortable that the business will provide the purchaser with the opportunity to achieve the desired goals before investing a significant amount of time and expense arranging a deal.

Employee Considerations

In a successful company, the owner(s) have typically developed and depended on certain key employees for a number of years. The employer may have promised certain benefits, such as deferred compensation that is payable to these employees after a company sale takes place. The owner(s) will want to make sure that the employees are comfortable with the new ownership and that their promised future benefits are secure.

Evaluating the business

In addition to the seller’s evaluation of the purchaser’s qualifications, the purchaser should evaluate the business. The keys to an effective business evaluation are:

* **Having reliable information**. Information gathering should begin as soon as the purchaser begins to consider buying the business. Information should be obtained from several sources, including the company, vendor, and customers. This information can be used to verify, compare, contrast and discover data about the owner, industry, business being acquired, and competitors. Of particular interest is information the seller may be reluctant to disclose (e.g., pending regulatory requirements, competition, etc.).
* **A well-prepared, experienced evaluation team.** Members of the evaluation team might include CPAs, attorneys, finance specialists, valuation specialists, environmental specialists, and investment bankers. It is important that people familiar with business valuation techniques are involved and that they use a disciplined valuation approach.

Business evaluation sounds simple, but in practice the effort is intense and compressed into a relatively short amount of time.

Performing due diligence

***Due diligence*** refers to the process of conducting an investigation to determine the full implications of a proposed transaction. One goal is to make sure the buyer and lenders know exactly what they are getting into. However, it can also benefit the seller by giving assurance that the buyers possess the skills and financing needed to successfully run the business and, therefore, repay any seller-financing. It also helps make sure that the seller understands the tax consequences of the sale.

Practically speaking, the primary lender prescribes the nature and extent of the due diligence required. The purchaser and the seller are generally already familiar with much of the information obtained in a due diligence review. Nevertheless, due diligence can uncover issues of which neither side is aware.

It is prudent for all parties involved (buyer, seller, and lenders) to agree in advance on the experts to use for due diligence. Agreeing on valuation, environmental, and legal experts will avoid the expense of each party hiring its own (although each party will probably want to retain separate legal counsel for negotiation purposes).

Structuring the purchase

A business transfer to a third party can be structured in a number of ways. Usually, a significant amount of negotiation is required to agree on the structure (e.g., stock purchase versus an asset purchase) since it has important tax, legal, and business consequences for all parties. Not only must the parties decide what they want from the deal (e.g., stock or assets, liability protection, etc.), they must quantify how much they are willing to pay for it (usually in the form of a price adjustment).

Financing the transfer

Purchases of family businesses are usually financed with a combination of loans and equity. The components often come from different sources. Depending on its size and complexity, the financing package can be assembled by a bank, commercial finance company, business broker, or investment banker.

Alternatively, the purchase may involve an installment loan financed by the seller. If the purchaser is a large company, the purchase may also be accomplished in the form of debentures or bonds.

# Option Three: Selling to Co-Owners

In most closely-held companies, the most likely purchasers of a business interest when an owner, or an owner’s estate, wishes to transfer the ownership are the other partners or owners in the business. This, of course, assumes that the other owners are motivated to continue the enterprise. This strategy also typically mitigates concerns regarding successor leadership and management of the enterprise because, presumably, the other owners are active in the business. In such circumstances, business succession planning really becomes more of a business continuation planning issue, which we discuss in some detail in another course.

A primary tenant of business continuation planning with multiple owners is to establish a Buy-Sell Agreement among the owners. This is a contract that delineates the terms of a future stock/asset transaction between specific groups or individuals. It may include a trigger event, such as death, disability, divorce or departure and will typically address how the purchase is to be funded.

There are two primary types of Buy-Sell Agreements: **Click each type to learn more.**

Entity Purchase Agreements

In an ***Entity Purchase Agreement***, the company (the entity) agrees to purchase the shares (business interest/assets) from a shareholder (owner or co-owner) upon some trigger or option event. It is also sometimes referred to as a ***Stock Redemption Purchase Agreement***.

Cross-Purchase Agreements

In a ***Cross-Purchase Agreement***, the shareholders (co-owners) mutually agree to purchase the shares (business interest/assets) from a departing shareholder (co-owner) upon some trigger or option event.

Each type of agreement results in different advantages and disadvantages, depending on the varied business structures, objectives, parties of the agreement, and circumstances of each company. Regardless of the type of agreement drafted for a particular business, Buy-Sell Agreements always offer the following benefits to the business owners:

* Peace of mind to the owners, heirs of owners, creditors, vendors and employees of the company
* Guarantees a market for the business interest
* Assists in estate planning for the owners; cash can be provided at sale and the Agreement may establish the taxable estate value of a decedent’s interest that will hold up to IRS scrutiny
* Allows surviving owners a pre-determined allocation of ownership in the business.

# Option Four: Selling to Employees and Management

Sometimes the best option for a business succession plan is to transfer the business to the employees and/or management of the business. The owner’s sense of commitment to long-time employees may also be a factor that makes this option more attractive.

This section will discuss four methods of transfer commonly used with employees and management:

1. Cash or Installment Sale by Owner
2. A Leveraged Buyout (LBO)
3. An Employee Stock Ownership Plan (ESOP)
4. Stock Bonus Plan

# Cash or Installment Sale by Owner

A “Management Buy-Out” is often the best option for a succession plan when an individual or team of ready, willing and able managers is prepared to make a purchase.  This solution, after many years of business development with a management team, can be very rewarding and satisfying for many business entrepreneurs. This option is also an excellent way to keep the business independent and ensure that it will continue operating.

Naturally, this process involves negotiations regarding price/valuation, terms, and what role the departing owner will play, if any, in the future. Often, the departing owner will continue in a consulting or even management capacity. This may serve multiple purposes:

* The selling owner may receive needed compensation to assist in retirement planning.
* Compensation payments to the selling owner are deductible to the company.
* Compensation to the selling owner may serve to lower the selling price.

In some cases, the buyers will have sufficient cash on hand to complete purchase of the business immediately, but in most cases they will need to finance at least a portion of the purchase. One solution is for the seller to take a note for the amount of the purchase price not received in a down payment by the buyers. This type of arrangement has advantages and disadvantages. **Click here to learn more.**

|  |  |
| --- | --- |
| **Advantages and Disadvantages of Seller Financing** | |
| **ADVANTAGES** | **DISADVANTAGES** |
| It extends the buyers’ burden of payments over years. | The buyers will probably need to pledge stock or assets as collateral. This can limit other business finance options and divert capital for other business purposes. |
| The seller reports gain on sale as payments are received. | Payments are with after-tax dollars. |
| Terms with the seller may be more favorable than with a bank. | The seller will be able to diversify his or her portfolio only as quickly as payments are made. |
| The sale is private. | An installment sale comes with the risk of the continued operation of the business. |
|  | Some risk arises if the owner has not sold majority control, or substantially all of his or her stock. In such cases, the IRS may determine that the sale of stock did not substantially reduce the owner’s effective ownership, so the IRS will tax the income as dividends rather than as capital gain. |

# Leveraged Buyouts (LBO)

A ***Leveraged Buyout (LBO***) is the purchase of a company’s stock or assets by a small group of investors. The transfer of the business is financed by debt that is secured by the assets of the business.

In an ***Employee Leveraged Buyout***, a management group purchases the business, usually aided by primary and secondary lenders, such as banks. In very large transactions, the financing is provided by issuing debt securities to the public through an investment banker.

The responsibility of paying off the debt falls on the company itself. This means that the new owners must generate enough cash from the business to meet the interest and principal payments on the debt. Debt is used to supplement the buyer’s capital and provides a higher return on equity when things go well. The appropriate amount of leverage depends on several factors, including reliability of cash-flow projections, industry and business trends, and the specific business purchase transaction.

Often, a leveraged buyout is considered for transferring ownership of a business when the owner has no heirs who are willing or capable of running the business and there is a capable management group in place. Following are several examples of when an owner may wish to consider an employee LBO as a succession planning technique:

* The owner feels commitment toward employees.
* The owner wants to preserve the identity of the business.
* The business has a strong buyout group.
* The owner and buyers with to accomplish a seamless and private sale.
* The market for a third-party is limited.
* When the cost of debt is less than the cost of equity, and management is not averse to the resulting level of debt.

### Click here to review advantages and disadvantages of an LBO

|  |  |
| --- | --- |
| **Advantages and Disadvantages of an LBO** | |
| **ADVANTAGES** | **DISADVANTAGES** |
| The seller receives cash from the sale. | The buyers will probably need to pledge stock or assets as collateral. This can limit other business finance options and divert capital for other business purposes. |
| The sale is private. | Payments are with after-tax dollars. |
| It extends the buyers’ burden of payments over years and payments are made from the business. | Debt payments may strain cash flow of the business. |

# Employee Stock Ownership Plans (ESOP)

An ***Employee Stock Ownership Plan (ESOP)*** is a special type of qualified retirement plan established for the benefit of a corporation’s employees. S Corporations, as well as C Corporations, can adopt an ESOP, although there are restrictions and limitations on the use of ESOPs by S Corporations. Unlike the typical qualified plan, an ESOP invests primarily in the employer’s stock. The ESOP may borrow in order to buy the stock and the debt is paid out of the employer’s contributions to the ESOP.

In business succession planning, ESOPs can be used to create a market for the sale of shares of a closely held corporation or as a vehicle to diversify an owner’s stock holdings. The following example illustrates how this might be done:

An architectural firm, which specializes in civic and major commercial designs, has established an ESOP, but intends to leverage it (i.e., borrow money for it). The company approaches a lender who accepts the company’s collateral, as in a traditional loan. The company then lends the cash from the loan to the ESOP. Subsequently, the ESOP exchanges the cash for the allotted stock. The stock is then allocated to the employee participants in the plan. If the primary/majority stockholder opts out of the plan, his or her ownership will be steadily diluted.

Like all other methods of transfer in a business succession plan, there are advantages and disadvantages to employing an ESOP. The advantages of using an ESOP are as follows: **Click each advantage to learn more.**

Tax Implications to Company

As long as the plan remains qualified, contributions to the plan by the company are tax deductible.

Financial Benefits

An ESOP allows the employees to retain ownership of the company and the company/corporation receives the full fair market value of the stock. Also, financing can be easier and less expensive.

Faster Close

The buyer is willing and ready to purchase with no protracted negotiations. Management support is a distinct advantage to the ESOP, which carries with it the ability to close quickly.

Minimized Disruption

The ESOP allows the business to continue without any disruption to customer relationships. Employees are not threatened by a pending sale, and loyal managers and employees are rewarded. Management can thus focus its attention on running the business efficiently, without diverting its attention for extended periods.

The principal disadvantages and possible problem areas that should be evaluated in considering an ESOP are as follows: **Click each disadvantage to learn more.**

Tax Implications to the Seller

A significant potential problem with an ESOP purchase of a *majority* owner’s shares is that the IRS may deem the stock sale as a dividend vs. a capital transaction. This would make the proceeds in a sale by a controlling owner immediately taxable as ordinary income to the seller.

If the selling shareholder is not deemed to have received a dividend in the sale of stock to the ESOP, the tax benefits are substantial if certain conditions are met. The primary condition is that no gain is recognized at sale by the seller if he or she reinvests the sale proceeds in qualified replacement securities, i.e., most common or preferred stock, bonds, and/or debt instruments issued by publicly traded or closely held domestic corporations.

Availability of Funds

The amount of funds available in the ESOP to purchase the stock may be limited, particularly when annual contributions are limited to 25% of participant covered payroll and the owner opts to be excluded from the plan to avoid share ownership.

Fiduciary Liability

The plan committee members who administer the plan are deemed to be fiduciaries and can be held liable if they knowingly participate in improper transactions.

Valuation

The company must incur the cost of annual valuations in order to establish the value of the stock for purposes of purchasing the stock, allocating the stock, and distributing the stock.

If considering the use of an ESOP to purchase stock of a company from an owner of the company, highly qualified advisors should assist in determining the tax ramifications of the transaction. At best, use of an ESOP would most often be used as a partial solution to purchasing a majority stockholder’s interest in a company. It could be of more substantial value when departing shareholders each own less than a controlling interest in the company and it is the management team’s desire to turn over control of the company to the employees.

# Stock Bonus Plan



A Stock Bonus Plan is essentially a qualified profit sharing plan where contributions to the plan are in company stock. Contributions must adhere to ERISA and Department of Labor rules and regulations regarding non-discrimination, contribution limits, etc.

If the owner’s objective is to transfer ownership to all employees in proportion to their income, this type of plan works well. Otherwise, ownership transfer is dispersed and may not target specific employees that the departing owner prefers to favor with increased ownership. Note, too, that contributions to the plan are tax deductible. The owner receives no proceeds as payment for his or her stock in this type of ownership transfer. Over time, depending on compensation levels, value of the company, number of plan participants, etc., the majority owner’s ownership percentage will be steadily depleted as the vested bonus plan account balances of participants accrue more and more stock.

# Option Five: Going Public

Going public is a complex, time intensive succession strategy. Rarely is it used as a pure exit strategy because it doesn’t address management transition. In fact, the market will insist that one already have a strong management team in place, rather than one in transition.

However, for those times when the use of public markets is part of a succession plan, the following considerations should be given: **Click each consideration to learn more.**

Management Depth

The owner must bring in, train, and virtually turn over the company to the management successor, whether a family member or an outsider. The prospect of going public might even be used to lure in a seasoned manager who wants to be aggressive.

Board of Directors

The company will need a board of directors that can handle the pressure and stress of a public company. To protect the family’s financial stake in the future of the company, one or more board members might be family members.

Percentage of Ownership Retained

Typically, an initial public offering is to sell 20 to 50 percent of the company, leaving the family as majority owners. Going forward, the family may desire to slowly sell the remaining portion of stock.

Compliance

Going public requires that an owner comply with many strict regulations. To accomplish this, an owner must involve lawyers, CPAs, and stock market analysts. The company will also need to have three to five years of clean, audited financial statements. If past financial statements have not been audited, going public may be at least three years away because the expense of auditing past statements is typically prohibitive.

# Option Six: Closing the Business

Finally, we consider the prospect of simply closing the business. There are many reasons why closing the business might be the appropriate succession plan, and one should not assume that closing the business represents failure. Sometimes, an owner will achieve maximum family harmony and financial return by simply deciding to close the business. Below are a number of reasons that make business closure an attractive option. **Click on each to learn more.**

Management Crisis

Especially in smaller companies, an owner who has not taken any steps toward forming a succession plan may be the only person who knows the business and has the experience to make decisions. If this person dies or becomes incapacitated, the family’s only realistic option may be to close down.

Family Squabbles

When the family cannot decide what to do with a company, closing is always an option. While the owner recognizes that this approach may not maximize financial return, it may be the best way to maximize family harmony.

Poor Past Performance

If the company was hit hard during a downturn and is struggling to return to financial health, the company might be viewed as “damaged goods.” In this case, the best option for maximizing the financial return might be a near-term liquidation of assets to recover as much value as possible.

Liability Worries

It is unpleasant to consider and difficult to discuss, but one cannot ignore the possibility that, depending on the company’s size and insurance coverage, a catastrophic event or two could financially wipe out the owner. It is possible that closing the business would be the best option to reduce the owner’s personal liability.

# Concern #3: "Will I have Sufficient Resources for Retirement?"

The need for financial security in retirement may be an overriding concern of an owner who is transferring a business to a successor. In fact, this need may be a key driver in determining the transfer options an owner is willing to consider.

In this section of the course, we will list and discuss the potential for previously reviewed transfer techniques to assist in satisfying a need for retirement income. In addition, we will review options related to the business that can also assist the owner in his or her retirement planning. It is beyond the scope of this course to review any of these techniques or options in detail; rather, our goal is to highlight their impact on retirement planning.

The selling owner’s selection of transfer techniques will be heavily influenced by the amount of assets, particularly income-producing assets that he, she or a spouse may own outside of the business interest. Substantial non-business assets allow the selection of techniques that weigh more heavily toward those that alleviate family and estate planning issues. In contrast, if a business asset makes up a substantial portion of the selling owner’s assets, he or she will likely prefer a succession plan that emphasizes retirement income and/or substantial assets to the seller.

# Transfer Techniques and Retirement Planning

An owner will usually be sensitive to income-producing retirement assets being provided by a business transfer in proportion to the income-producing assets he or she owns outside of the business interest. The nature of the outside assets and other, more personal issues, may be factors as well. For example:

* Is an inheritance anticipated?
* Over time, will the owner be able to convert non-income-producing assets to income-producing assets?
* Does the owner have substantial debt, obligations, or contingent liabilities?
* What is the status of the owner’s health and/or his or her spouse?

As you review these various techniques, consider owners in various financial and personal circumstances. **Click on each Transfer Technique to learn more.**

Cash or Installment Sale of the Business

A *cash sale* certainly is the cleanest and easiest business transfer method to evaluate for retirement planning purposes. Cash is in hand, taxes must be paid resulting from the sale, and the seller knows how much net cash is available to invest and apply to debt or to any other financial needs that arise.

An *installment sale* has similar ramifications to a cash sale except the receipt of payments and tax liabilities from the sale are spread out over time. The seller incurs the risk of a creditor.

Consulting Contract

In some cases, the buyer will wish to retain the selling owner on the payroll, with benefits, or as a consultant for a specified period of time. If the seller is amenable to this arrangement, the extra income and/or access to benefits may be a meaningful “bonus.”

SCINS and Private Annuities

If the seller accepts a SCIN or Private Annuity as payment in a family sale, the risk of death prior to full payment on the note should be a risk that the seller can afford to take. Motivation for this arrangement probably is primarily driven by accommodating a family member’s ability to purchase the business.

Asset Sales

While an asset sale produces no direct retirement income for a sole proprietor, since the sales proceeds will pass through to the owner they can be invested to produce income.

Business Retirement Plans

*ESOPs and Stock Bonus Plans* in a small or closely held corporation serve to increase the number of shares held by the owner. If other employees receive substantive allocations from these plans, the primary owner’s percentage of ownership may be somewhat diluted. In any case, these shares would likely be included in a sale of the business.

A *qualified retirement plan*, particularly if substantial contributions have been allocated to the selling owner for several years, could be a significant source of retirement income to the seller. These funds are generally secure from company creditors, segregated from operational funds, and regulated by the IRS and DOL.

A *nonqualified deferred compensation plan* is a different animal. In this type of plan, assuming the seller is a plan participant, he or she is a creditor of the company. That is, the company has promised a specified amount of payments at a future date but the funding for this type of plan is not regulated and considered accessible to creditors. In some cases, depending on the plan design, the deferred compensation may be payable at time of sale. In any event, these issues should be addressed in the terms of sale. When applicable, deferred compensation could be a critical retirement planning factor to a selling owner and he or she will want to make sure receipt of these benefits are as secure as possible.

Recapitalization

A recapitalization involving an issue of preferred stock in exchange for common stock is intended to have two primary financial impacts to the senior family business owner. First, the common shares with growth potential are removed from the ownership of the senior owner for estate planning purposes. Second, the preferred stock, owned by the senior owner, will provide a predictable income stream of priority dividends.

A recapitalization involving a change to split the ownership of voting and non-voting shares typically has no impact on cash flow to shareholders, but can be a useful “freeze” technique for estate planning purposes.

# Transfers by Gift

In family businesses, the transfer of a business interest may utilize gifting techniques to family members. On this page, we will overview the retirement planning ramifications of these gifting transfers. **Click on each Transfer Technique to learn more.**

Outright Annual Exclusion Gifts and Gifts Using the Lifetime Gift Tax Credit

Outright gifts have no impact on providing extra income to the donor. In fact, they may reduce donor income. Thus, we assume when outright gifts are made, retirement income is not a consideration to the donor/senior family business owner; instead, he or she is trying to reduce the size of his or her taxable estate and/or is focused on transferring a business interest to another family member(s).

Family Limited Partnerships (FLPs)

An FLP is a technique used by senior family members who own business and/or other assets of substantial value and want to shift income generated by those assets to other members of the family who may be in lower income tax brackets and/or to reduce the estate tax eventual liability of the senior family members. The design of the FLP can provide income to the donor, depending on the specific estate planning objectives of the donor.

Grantor Retained Annuity Trusts (GRATs)

A GRAT is primarily an estate transfer technique, but it provides income for a specified period of time. This technique works much better if the business entity is able to pay substantial cash flow, preferably by a flow-through entity such as an LLC or Sub S Corporation.

# Review Exercise

1. Which of the following is NOT an approach to selling a business to a third party?
   * Stock sale

Incorrect. Try again.

* + Assets sale

Incorrect. Try again.

* + - GRAT

Correct.

1. Which of the following statements is/are TRUE regarding considerations when selling a business to a third party?
   * When investigating the potential buyer, the owner should evaluate the purchaser’s motives.

Incorrect. This is not the only true statement.

* + Before selling the business, the owner should obtain an accurate and objective valuation of the business.

Incorrect. This is not the only true statement.

* + It is important to decide on a purchase structure that is satisfying to both parties.

Incorrect. This is not the only true statement.

* + - All of the above are true

Correct!

1. When transferring the business to employees, a leveraged buyout will result in pledging company assets to secure the acquisition debt.
   * + True

Correct!

* + False

Incorrect.

1. An ESOP is a purchase of the business by a management group, usually aided by primary and secondary lenders.
   * True

Incorrect. This describes a leveraged buyout, not an ESOP.

* + - False

Correct! This describes a leveraged buyout, not an ESOP.

1. Which of the following statements is/are FALSE regarding Employee Stock Ownership Plans?
   * It is actually a type of qualified retirement plan.

Incorrect. This is a true statement. Try again.

* + The ESOP invests in employer stock.

Incorrect. This is a true statement. Try again.

* + - The ESOP may not borrow funds to purchase employer stock

Correct! An ESOP can borrow funds to purchase employer stock.

* + ESOPs can be used to create a market for the sale of shares of a closely held corporation

Incorrect. This is a true statement. Try again.

1. Which of the following is NOT an advantage of an ESOP?
   * Allows employees to retain ownership of the company

Incorrect. This is an advantage of an ESOP. Try again.

* + ESOPs allow the business to continue operating without disruption while the business is transferred

Incorrect. This is an advantage of an ESOP. Try again.

* + The purchase is closed faster than usual

Incorrect. This is an advantage of an ESOP. Try again.

* + - All of the above are advantages

Correct!

1. Which of the following considerations should be given when taking a business public?
   * Management depth

Incorrect. This is not the only consideration.

* + A board of directors will be needed

Incorrect. This is not the only consideration.

* + Compliance with regulations

Incorrect. This is not the only consideration.

* + Percentage of ownership retained

Incorrect. This is not the only consideration.

* + - All of the above

Correct!

# Conclusion

This concludes the material for this subject. At this time you may return to any sections in which you feel the need for further study.