2019 Southern Arizona Estate Planning Council

Business Succession Planning

Presented by:
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Key Elements in the Planning Process

- Recognize that it is always about control
- Recognize that it is often about denial
- Recognize that the client often makes a wrong assumption
  - "I have a family, so I have a succession plan"
- Recognize that conflict may be inevitable if there are insiders (plunderers) and outsiders (parasites)

The Context of Planning for Business Owners

- People, property, process, pitfalls and plaintiffs
- Some realities of family business succession
  - Death and incapacity
  - Estate tax
  - There is no "equity value" in the family business
  - Conflict is inevitable
  - Tax problems are passed from one generation to the next
  - Divorce happens

Recognize the Difficulties of Transferring a Family Business through Multiple Generations

- Is there a succession plan?
  - Are there capable family members?
  - Has a successor been chosen — has any training occurred?
  - Are there rivalries within the generation of likely successors?
  - How will family members outside the business be treated?

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Recognize the Difficulties of Transferring a Family Business through Multiple Generations

- Has the business owner diversified his or her assets?
  - Are there assets equivalent to the business value to be left to other heirs?
  - Have issues regarding support of a surviving spouse and payment of estate and inheritance taxes been addressed?

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Address the Value of the Business

- "Fair market value" (willing buyer and seller)
- Valuation issues are often highly controversial. Rev. Rul. 59-60, 1959-1 CB 237
- Appraisals by independent, certified 3rd parties are highly recommended.
- Consider valuation discounts. Proposed Regs. Under IRC 2704
- Family control is disregarded in applying a minority interest discount for lack of control. Each piece of the transferred interest may be viewed separately and distinctly. Rev. Rul. 93-12, 1993-1 CB 202
- Consider the use of a "defined value gift" (*Wandry v. Commissioner*).
- Recognize that valuation is one of, if not <u>the</u> prime audit topic when a closely-held business is transferred.

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Address the Value of the Business

- Minority Interest Discount
- Lack of marketability discount
  - Absence of a ready market for the business interest
    - *Mandelbaum v. Commissioner*, TC Memo 1995-255; aff'd 91 F.3d 124 (3rd Cir. 1996)
- The built-in capital gain discount
  - This is available where the business could not be sold without triggering capital gain liability
    - *Eisenberg v. Commissioner*, 155 F.3d 50 (2nd Cir. 1998);
    - *Estate of Jensen v. Commissioner*, T.C. Memo 2010-182
  - Be sure that the structure of the business supports valuation discounts
    - LLC, S corporation, family limited partnership, non-voting stock, etc.
- QUERY: Is a discount desirable in the current environment?

Give the Business to Family Members

- Address the federal gift tax rules
  - Marital deduction: the unlimited gift tax marital deduction is available for transfers to a United States citizen spouse.
  - Annual gift tax exclusion for gifts of present interests in property
    - **$15,000 per donee for 2019. Will that move "enough"?**
    - **Spouses may split gifts.**
    - **Gifts of community property are automatically deemed split.**
    - **Be sure the gift creates a true "present interest" in the donee**
    - In whose name is the business held?

Give the Business to Family Members

- Address the federal gift tax rules
  - Consider the lifetime gifting exemption.
    - **Lifetime cumulative gift tax exclusion of $11,400,000 for 2019**
    - **By splitting gifts, a married couple has a combined available exemption of $22,800,000 million for transfers made in 2019. The portability rules make it possible to preserve this exemption for a surviving spouse.**
  - **Note the income tax basis rules.**
    - **Donee takes a carryover basis for income tax purposes for gifts from donors.**
    - **Heir takes a fair market value at date of death (or alternate valuation date) basis for income tax purposes from a decedent.**

Death, Liquidity and Code Sec. 303

- If the owner dies owning the business, address liquidity issues.
  - Sources of liquidity: Code Section 303 Redemptions to Pay Death Taxes
    - **Section 303 treats as an exchange (and not a dividend) a redemption of the decedent's stock so long as more than 35% of the decedent's adjusted gross estate consists of the stock of the closely held corporation.**
    - **To what extent may the redemption be utilized? (taxes, funeral and administration expenses)**
    - **In testing the 35% of the estate threshold requirement of Section 303, aggregation of interests in several closely-held businesses is available.**
    - **Be wary of an unintended dilution of the family interest. What is the percentage of voting equity before and after the redemption?**
    - **S Corporation shares are eligible – Can divide into voting and non-voting without violating the 2nd class of stock prohibition for S Corporations.**

Death, Liquidity and Code Sec. 6166

- Sources of liquidity: Code Section 6166 Installment Payments
  - **Congress enacted a relief provision to permit the deferral of estate tax payments (Code Section 6166).**
  - **Section 6166 is available only if the decedent was a U.S. citizen or resident at the time of death and the value of the decedent's interest in a closely-held business exceeds 35% of the value of the decedent's adjusted gross estate. Interests in small businesses at least 20% owned can be aggregated to meet the 35% test.**
  - **The deferral is not available for passive assets.**
  - **If these tests are met, the personal representative of the decedent's estate can elect to defer completely for 5 years payment of the portion of the estate taxes attributable to the closely held business interest and thereafter pay the deferred portion of the estate taxes in up to 10 annual installments. The estate tax attributable to non-closely held business assets is due at the regular time, i.e. 9 months from the decedent's date of death.**

Section 6166 Installment Payment Election

- Sources of liquidity: Code Section 6166 Installment Payments
  - **Interest is charged on the unpaid balance of the installments of tax that are due. The rate is 2% on the first $1,550,000 of tax, and 45% of the IRS underpayment rate on the balance due.**
  - **The interest payments made by the estate are not deductible as an estate administration expense for estate tax purposes, nor are they deductible for income tax purposes.**
  - **In order to obtain the benefits of Section 6166, an election must be made on Form 706 no later than the time for filing the federal estate tax return, including extensions.**

Code Sec. 6166 – Issues to Be Considered

- Sources of liquidity: Code Section 6166 Installment Payments
  - **A bond may be required to be posted to secure the payment of the deferred tax.**
  - **Be careful if a business interest for which a Section 6166 election was made is sold on an installment basis.**
  - **Acceleration of the balance due is possible if 50% or more of the business is sold, or the required payments are late.**
  - **S corporations, LLCs, partnerships and sole proprietorships may use Code Section 6166.**

More Sophisticated Transfer Techniques

- Consider advanced estate planning techniques to freeze the value of the business and/or transfer it to the next generation.
  - Self-Canceling Installment Note (SCIN)
  - Private Annuity
  - Grantor Retained Interest Trusts
  - Installment Sales to Intentionally Defective Grantor Trusts
  - The Charitable Bail-Out: Transfer the Family Business Interest and Receive a Tax Deduction
  - Family Partnerships and LLCs as Family Transfer Vehicles
  - Multi - Generation-Skipping Transfer Tax Planning: Using Dynasty Trusts

Self-Canceling Installment Note (SCIN) (A Bet-To-Die Strategy)

- **SCIN involves the sale of property (typically to children) in exchange for an installment note calling for a specified number of fixed payments at a specified interest rate over a set period of time, but also provides that the note payments terminate upon the death of the seller.**
- **Since death terminates the seller's right to receive payments, there is nothing of value to include in the seller-decedent's estate.**
- **Cases: Estate of Moss, 74 TC 1239 (1980) acq. 1981-1 C.B. 2**
- **Estate of Costanza v. Commissioner, 320 F.3d 595 (6th Cir. 2003), rev'g, T.C. Memo. 2001-128**
- **Gift tax issue is avoided by reflecting the self-canceling feature as part of the bargained-for consideration for the sale, by either placing a premium on the price to be paid for the business interest or by stating an interest rate for the note substantially above the market rate.**

Planning with SCINs

- The purchaser's basis in a SCIN is stepped up at the time of sale to the face amount of the note.
- The ideal candidate for a SCIN has a shorter actual life span than would be indicated by his/her actuarially projected life expectancy. The earlier into the specified term the seller dies, the more advantageous the SCIN is. This is because the property transferred plus all the appreciation and it has produced is removed from the transferor's estate

Planning with SCINs

- "A SCIN signed by family members is presumed to be a gift and not a bona fide transaction." However, the presumption could be rebutted by an affirmative showing that there existed at the time of the transaction a real expectation of repayment and intent to enforce the collection of the indebtedness.
- In Estate of Musgrove v. United States, 33 Fed. Cl. 657 (1995) a demand SCIN transaction was not recognized as a bona fide transaction because of the absence of a real expectation of repayment (since the seller was in poor health and the purchaser did not have other funds and the seller declared that he was not likely to demand payment on the note), and the SCIN was included in the decedent's gross estate.

Planning with SCINs

- IRS Pronouncement: CCA 201330033:
- The CCA observes that the exchange of property for a promissory note is not treated as a gift "if the value of the property transferred is substantially equal to the value of the notes."
- IRS: Don't value the note using the IRC Section 7520 rate, The notes should be valued based on a method that takes into account the willing-buyer willing-seller standard. In this regard, the decedent's life expectancy, taking into consideration decedent's medical history on the date of the gift, should be taken into account.
- Dallas v. Commissioner, T.C. Memo. 2006-212 appears to have used §7520 in valuing a SCIN.

Planning with SCINs

- ESTATE OF DAVIDSON, TAX COURT CAUSE NO. 013748-13 (FILED JUNE 14, 2013) Davidson was the President, Chairman, and Chief Executive Officer of Guardian Industries Corp., one of the world's leading manufacturers of glass, automotive, and building products. Before various gift and sale transactions in December of 2008, he owned 78% of the common stock of Guardian. He is a prior owner of the Detroit Pistons NBA team. The decedent (age 86) entered into various gift and sale transactions in December 2008 and January 2009, include large sale transactions for self-canceling installment notes. Soon after these transactions, he was diagnosed with a serious illness and he died on March 13, 2009 (before he received any payments on the notes). The IRS Notice of Deficiency alleges gift, estate, and GST tax deficiencies of well over $2.6 billion.

Planning with SCINs

- Termination of SCIN has potentially adverse income tax consequences:
  - Unrealized or unreported installment sale gain must be reported as a result of seller's death on the basis that the deferred gain was income in respect of a decedent transferred by the decedent's estate. (Frane v. Commissioner, 998 F.2d 567 (8th Cir. 1993). It is reported on a fiduciary income tax return.
- The SCIN works "best" if seller does not survive the term of the note.

Private Annuity

- **A planning transaction that may work successfully when there is a business owner who wants to transfer the business interest and continues to receive income, but who may have a reasonably short life expectancy.**
  - **In the private annuity transaction, the business owner (transferor) transfers ownership of the business to the family member (transferee) in exchange for the transferee's promise (which must be unsecured) to make payments to the transferor for life.**
  - **Value annuity correctly to avoid or address a gift or partial gift issue**
  - **2006 Proposed Regulations that would require the transferor of the business interest to recognize the entire realized gain for income tax purposes at the time of the exchange.**
  - **If the private annuity is structured successfully, there is no gift tax cost and the value of the annuity is not included in the annuitant's estate.**
  - **Don't use the transferred property to satisfy the annuity payments.**
  - **If the annuitant has a short actual life expectancy the private annuity "works best" for estate tax purposes.**

The Client Is Not Ill, Wants Estate Reduction, Wants to Transfer Assets but Wants Some Return on the Assets Transferred
Planning with GRATS:
A "Bet to Live" Strategy

Code Section 2702
Sets the Ground Rules

- Code Section 2702 provides special rules to determine the amount of a gift when an individual makes a transfer in trust to (or for the benefit of) a member of the individual's family and the individual or an applicable family member of the transferor retains an interest in the trust.

The Effect of Code Section 2702

- If Section 2702 is found to be applicable to a transfer of an interest in trust, and none of the exceptions to Section 2702 coverage apply (the exceptions are discussed below), then the interest retained by the transferor or an applicable family member is valued at zero
  - This means that the entire fair market value of the transferred property in which the transferor has retained an interest is subject to gift tax as of the date of the transfer
  - Conversely, if an exception to Code Section 2702 is applicable, the retained interest is recognized as "qualified," so that the amount of the gift is measured by the fair market value of the transferred property <u>less</u> the value of the interest retained by the transferor or applicable family member

Key Definitions for Section 2702

- Member of Family
- Transfer in Trust
- Retained Interest

Grantor Retained Interest Trusts

- Code Section 2702 provides special rules to determine the amount of a gift when an individual makes a transfer in trust to or for the benefit of a member of the individual's family and the individual retains an interest in the trust.
- "Qualified interest" includes any interest which consists of the right to receive either fixed amounts payable at least annually or the right to receive annual payments of a fixed percentage of FMV of trust property as determined annually.
  - GRAT
  - GRUT

Qualified Annuity and Unitrust Interests—General Rules

- The term "qualified interest" means
  - Any interest consisting of the right to receive fixed amounts payable not less frequently than annually
    - A qualified annuity interest, a.k.a. a GRAT (grantor retained annuity trust)
  - Any interest consisting of the right to receive amounts payable not less frequently than annually which are a fixed percentage of the fair market value of the property in the trust (determined annually)
    - A qualified unitrust interest, a.k.a., a GRUT (grantor retained unitrust)

Qualified Annuity and Unitrust Interests—General Rules

- Distributions from the trust to or for the benefit of any person other than the holder of the qualified annuity or unitrust interest during the term of the qualified interest must be prohibited by the governing instrument
- The term of the annuity or unitrust interest must be fixed by the governing instrument
- The grantor may act as the trustee of a qualified annuity or unitrust

Special Rules for Qualified Annuity Interests (GRATs)

- A qualified annuity interest is an irrevocable right to receive a fixed amount
  - A stated dollar amount payable periodically
  - A fixed fraction or percentage of the initial fair market value of the property transferred to the trust
- A right of withdrawal, whether or not cumulative, is not a qualified annuity interest
- Additional contributions to the trust must be prohibited by the governing instrument

Grantor Retained Interest Trusts

- GRATs and GRUTs
  - Irrevocable trusts to which the trust grantor transfers property while retaining the right to receive an annuity or unitrust interest for a fixed term of years. Upon expiration, the property passes to the designated remainder beneficiaries.
  - Transfer tax advantage of GRATs – reduced gift tax on transfers.
  - The *Walton* GRAT is a zeroed-out GRAT – avoids any gift tax.
  - GRATs and GRUTs are most effective to accomplish their intended transfer tax savings if the grantor survives the term of the trust. But a 99-year GRAT can work as well.
  - GRATs and GRUTs will qualify as S corporation shareholders provided they are treated as grantor trusts for federal income tax purposes.

Income Taxation of GRATs and GRUTs

- The ordinary income and capital gains earned by a GRAT or a GRUT during the retained interest term should be taxed to the trust grantor under the grantor trust rules
  - When the grantor transfers assets to a GRAT or GRUT to fund it, there is no recognition of gain or loss to either the grantor or to the GRAT or GRUT, regardless of the value of the property and its basis to the grantor
  - The grantor's individual tax rates, rather than the trust's, become the measure of tax liability
  - As a grantor trust, the trust may hold S corporation stock during the grantor's retained interest term

Gift Taxation of GRATs and GRUTs

- For gift tax purposes, the general rule of Code Section 2702 is that the value of any interest retained by the grantor or any applicable member of the grantor's family is zero, unless the grantor's retained interest is a qualified annuity or unitrust interest
- If the trust meets the requirements of a qualified annuity or unitrust interest as described above, the retained interest is acknowledged and the value of the gift is the fair market value of the property transferred to the trust, less the present value of the qualified interest
- The gift of the remainder interest is the gift of a future interest

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Gift Taxation of GRATs and GRUTs

- The value for gift tax purposes of a transfer of property to a GRAT or GRUT will depend on the following factors
  - The value of the property transferred to the trust
  - The Code Section 7520 rate for the month in which the property is transferred to the trust
  - The amount of each annual unitrust or annuity payment
  - The time period (a term of years) over which the unitrust or annuity trust payment is to be made
  - The age of the grantor

Estate Taxation of GRATs and GRUTs

- Death after the retained interest term
  - If the grantor survives the retained interest term of the trust, the trust principal, including all appreciation in the value of the trust property subsequent to its transfer to the trust, is removed from the grantor's taxable estate, assuming, of course, that the grantor retains no interest in the trust beyond the retained term
  - To the extent of the value of the gift taxable portion of the transfer to the GRAT or GRUT in the year of its creation, such value must be reported in the grantor's estate upon the grantor's death as an adjusted taxable gift

Estate Taxation of GRATs and GRUTs

- The obvious advantage of outliving the retained interest term suggests that a grantor should be realistic in the selection of a term within his or her reasonably anticipated life expectancy
- If the grantor outlives the term, and the property appreciates, all of the appreciation is excluded from the grantor's estate

Estate Taxation of GRATs and GRUTs

- Death during the retained interest term
  - If the grantor does not survive the trust term, the GRAT constitutes a retained interest in the decedent's estate
  - The portion of the trust corpus includible in the decedent's gross estate is that portion of the trust corpus valued at date of death (or alternate valuation date) necessary to yield the required annuity annual payment using the appropriate Section 7520 interest rate in effect on the date of the decedent's death

Estate Taxation of GRATs and GRUTs

- Where the grantor's death prior to the expiration of the trust term forces an estate inclusion, the grantor's estate is entitled to a credit for any gift tax that was paid at the time the trust was created
- Although the regulations prohibit the commutation of the grantor's retained interest in a qualified annuity or unitrust, they do not prohibit the retained interest from being sold

A Note on Basis

- If the grantor outlives the term of the trust, the remainder beneficiaries take the trust property with the carryover income tax basis from the grantor
- If the grantor dies within the term of the trust, the remainder beneficiaries take the property with a basis equal to its value at the grantor's death

Generation-Skipping Transfer Taxation of GRATs and GRUTs

- These trusts should not be used as vehicles to attempt to reduce or avoid generation-skipping transfer tax issues
- An attempt to allocate generation-skipping transfer tax exemption will not be effective until the end of the estate tax inclusion period (ETIP) Code Section 2642(f)(3).
  - For a GRAT or GRUT, this will not occur until the grantor's retained income interest terminates
- The grantor cannot allocate generation-skipping transfer tax exemption in an amount equal to the present value of the remainder interest gift at the time of creation of the trust

Planning Considerations and Techniques
Use of S Corporation Stock

- A GRAT or GRUT is a permitted S corporation shareholder
- The idea is to transfer a minority interest in an S corporation to a GRAT, taking advantage of the discounts for minority interest and lack of marketability, followed by the actuarial calculation of the GRAT retained and remainder interests

Planning with Short-Term GRATs and GRUTs

- The obvious advantage of the short-term GRAT is its ability to act as a hedge against the grantor's death during the retained interest term
- The use of short-term GRATs also creates a hedge against a possible bad investment or income year
- Potential disadvantages
  - If the Code Section 7520 rate increases
  - Administrative costs will be higher
  - A planned series of GRATs opens the grantor to possible changes in the law over time

Can a Note be Used to Satisfy the Annuity or Unitrust Payment?

- The IRS has prohibited the use of notes to pay the retained interest in a GRAT or GRUT on the theory that the use of notes delays the payment of the grantor's retained interest and alters its value

Ultimate Tax Planning
The Zeroed-Out GRAT

- A zeroed-out GRAT is a GRAT designed in such a way that the present value of the grantor's retained annuity interest is equal to the fair market value of the property transferred to the trust, resulting in a remainder interest valued at zero, and consequently, no gift for gift tax purposes
  - *Walton v. Commissioner*

Ultimate Tax Planning
The Zeroed-Out GRAT

- *Walton* allows the creation of GRATs with annuities that equal the value of the transferred property, so that all of the property, the income therefrom and the appreciation thereon at the assumed rate of return (i.e., the Code Section 7520 rate) return to the grantor in the form of an annuity
  - Accordingly, the value of the gift is zero
- Where the grantor may be survived by a spouse, steps should be taken to have the GRAT remainder interest as well as the grantor's right to continuing annuity payments be paid to the surviving spouse or to a marital deduction trust
- A **single asset GRAT** may be a wiser choice

Take Advantage of the Low Interest Rate Environment

- The performance of a GRAT improves with lower interest rates and declines with higher interest rates
- The Section 7520 rate is used to calculate the present value of the grantor's retained annuity
- As the rate declines, the annuity factor increases, so that a given annuity payment will have a greater present value, thereby increasing the value of the annuity retained by the grantor and reducing the value of the gift of the remainder interest
- If a GRAT fails to outperform the Section 7520 "hurdle" rate, it has failed.
- If there was no gift tax paid, the only real loss is the transaction costs incurred by the grantor

Consider the 99-Year GRAT

- The longer the term the lower will be the annuity required to zero-out the GRAT that is to produce no gift
  - Regulation 20.2036-1(c)(2) provides that where a grantor retained an interest in an annuity the value of the property included in the grantor's estate will be the amount required to produce the remaining annuity using the Section 7520 rate in effect at the grantor's death

Estate Tax Freeze: Installment Sales to Intentionally Defective Grantor Trusts

- Combines favorable estate tax planning with advantageous income and gift tax planning.
- Designed to allow an income tax-free sale of property with appreciation potential to be made to a trust whose beneficiaries are the heirs of the trust grantor.
  - Appreciation on property sold to trust is removed from the trust grantor's estate, if properly designed.
- Trust drafted so that grantor is treated as owner of trust for income tax purposes, but not for estate tax purposes.
- This is accomplished by including certain administrative powers in the trust to be retained by the grantor

Estate Freezes
Installment Sales to Intentionally Defective Grantor Trusts

- With the trust so prepared, the sale of assets by the grantor to the trust avoids capital gain taxes, and the note interest to be received by the grantor is not subject to income tax
- The transaction is treated as a sale by the grantor to him or herself (Rev. Rul. 85-13)
- Appreciation on the assets sold by the grantor to the trust grows outside the grantor's estate

Estate Freezes
Installment Sales to Intentionally Defective Grantor Trusts

- The only gift tax element of this transaction arises from the requirement that the trust must be capitalized ("seeded") with sufficient assets (other than the promissory note to be received) to establish the independence of the trust from the assets to be sold by the grantor to the trust

Estate Freezes
Installment Sales to Intentionally Defective Grantor Trusts

- Rev. Rul. 2004-64 held there was no gift by the grantor to the trust beneficiaries when the grantor paid the trust's income tax
  - **The grantor was satisfying the grantor's own obligation**
- A defective trust can be funded with S corporation shares
- It can be created with skip persons as beneficiaries.
- Cautions: 2017 Budget Proposals; *Karmazin*, *Woelbing* cases

Estate Freezes
Installment Sales to Intentionally Defective Grantor Trusts

- Sell the business to the IDGT – freeze and possibly discount the value – only the balance due on the note is included in the grantor's estate. Rev. Rul. 2008-22.
- Power of Substitution can "save" a higher basis
- **Freeze** the value; **Squeeze** the value if discounting applies; **Burn** off the grantor's assets by the payment of income tax.

The Charitable Bail-Out: Transfer the Family Business Interest and Receive a Tax Deduction

- 1st step: business owner contributes some or all of ownership interest in company to a qualified charitable organization.
- Owner's caution about transferring stock and the charity's lack of enthusiasm for holding the stock lead to the 2nd step in the charitable bail-out transaction–the redemption of the stock from the charity by the corporation.
- Where the owner's goals were not limited to making a tax deductible charitable gift but also included a transfer of a tax-free controlling interest in the business to children, this can also be accomplished.

The Charitable Bail-Out: Transfer the Family Business Interest and Receive a Tax Deduction

- IRS will attack a charitable bail-out transaction if it can show that there was prearranged legally binding obligation that gave business the right to compel the charity to surrender the shares for redemption. Rev. Rul. 78-197, 1978-1 C.B. 83; Blake v. Commissioner, 697 F.2d 473 (2nd Cir. 1982).
  - This contention can be overcome so long as it can be shown that the charitable organization was not legally obligated to sell the stock to the corporation or provide special value to the donor. Palmer v. Commissioner, 62 TC 684, aff'd 523 F. 2d 1308 (8th Cir. 1975); Caruth v. Commissioner, 865 F. 2d 644 (5th Cir. 1989).

Family Partnerships and LLCs as Family Transfer Vehicles

- “Easy” cases for the government to win are those involving deathbed transfers.
- Taxpayer victories generally address the “bona fide sale exception”.
  - If the taxpayer can show a significant non-tax business purpose for transferring assets, the taxpayer has a reasonable chance to prevail.
  - Case-by-case victories and losses by taxpayers.

Multi - Generation-Skipping Transfer Tax Planning: Using Dynasty Trusts

- Dynasty Trust provides for life estates in property for every generation of beneficiaries.
  - Typically structured to last for the maximum period of time permitted by state law.
- If a Dynasty Trust is created in a state that has abolished the rule against perpetuities, and funded with an amount equal to the maximum available GST tax exemption of the transferor, the trust property will not be subjected to any further estate, gift or GST tax liabilities (assuming the trust principal is not distributed to the beneficiaries).
- Offers the additional attraction of asset protection for future generations.

Dynasty Trust Opportunities

- Consider making the IDGT a Dynasty Trust for the lifetime benefit of children and grandchildren – and future generations.
- The GST exclusion in 2019 is $11,400,000 – it is NOT portable

Consider an ESOP (Employee Stock Ownership Plan)

- *To buy the shares of a departing owner:* Owners of privately held companies can use an ESOP to create a ready market for their shares. Under this approach, the company can make tax-deductible cash contributions to the ESOP to buy out an owner's shares, or it can have the ESOP borrow money to buy the shares.
- The ESOP borrows cash, which it uses to buy company shares or shares of existing owners. The company then makes tax-deductible contributions to the ESOP to repay the loan, meaning both principal and interest are deductible.
- *Sellers in a C corporation can get a tax deferral:* In C corporations, once the ESOP owns 30% of all the shares in the company, the seller can reinvest the proceeds of the sale in other securities and defer any tax on the gain. IRC 1042
- Private companies must repurchase shares of departing employees, and this can become a major expense.

Enter Into a Buy-Sell Agreement

- Considerations for Buyers and Sellers in Buy-Sell Agreements for Closely-Held Businesses
  - Objectives of a Buy-Sell Agreement for:
    - Entity
    - Deceased owner's estate
    - Retired or disabled owner
    - Remaining owners
- Types of Buy-Sell Agreements
  - Cross-purchase
  - Entity buy-out
  - Hybrid agreement

Enter Into a Buy-Sell Agreement

- Choosing the Right Type of Agreement
  - Number of owners
  - Premium payments on life insurance policies
  - Transfer for value problems
  - AMT problems (The corporate AMT has been repealed)
  - Accumulated earnings tax
  - Basis for income tax purposes

Suggested Terms for a Buy-Sell Agreement

- Triggering Events
  - The events triggering a purchase may include the death, retirement or disability of an owner, an attempted sale to a third party, and the termination of employment of an owner for reasons other than death, retirement or disability
  - Divorce, bankruptcy or insolvency of an owner may also trigger an option or obligation to purchase

Suggested Terms for a Buy-Sell Agreement

- Setting the Purchase Price
  - Use a fixed price
  - Consider having a different purchase price for different events
  - The IRS is very likely to reject a buy-sell agreement based on book value

Suggested Terms for a Buy-Sell Agreement

- The agreement may require that an appraisal be made at the time the interest of the withdrawing or deceased owner is to be purchased
- Another method bases the purchase price on the estate tax value of the deceased owner's interest
- Long history of controversy between taxpayers and the IRS over the issue of buy-sell agreements in general, and those involving family business interests in particular

Suggested Terms for a Buy-Sell Agreement

- The general rule of Section 2703 is that for estate, gift and generation-skipping transfer tax purposes, the value of any property is determined without regard to any right or restriction relating to the property
  - Exceptions to the general rule which provide that a right or restriction will not be disregarded if it satisfies each of the three following requirements:
    - The right or restriction is a *bona fide* business arrangement
    - The right or restriction is not a device to transfer the property to members of the decedent's family or to objects of the transferor's bounty for less than full and adequate consideration in money or money's worth
    - The terms of the right or restriction are comparable to similar arrangements entered into by persons in an arms'-length transaction at the time the right or restriction is created
  - It is difficult, but not impossible, to fit a family buy-sell agreement within the requirements of Section 2703

Payment Terms

- The buy-sell agreement should specify how the purchase price will be paid
- Most buy-sell agreements will permit a portion of the purchase price to be paid in installments

Should the Buy-Sell be Mandatory or Optional?

- A decision should be made whether the purchase or sale will be mandatory, or whether the entity or remaining owners will only have an option or right of first refusal

Restrictions

- Agreement usually should contain restrictions on voluntary transfers of interests in the business
- Transfers may be permitted to the owner's spouse or children, or to trusts created for their benefit, in order to allow the owners to engage in estate planning transactions
- Transfers to third parties may be permitted after first offering the interest to the entity or the other owners

THANK YOU