INTEGRATING VARIOUS BUSINESS SUCCESSION AND WEALTH TRANSFER PLANNING TECHNIQUES

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The vast majority of businesses in the U.S. are privately owned and need to establish a succession plan for key employees and family members. An effective succession plan provides a realistic road map for the continuation of the business after the retirement or death of the founder(s), while minimizing transfer taxes and addressing family dynamics.

In business succession planning, one size does not fit all. Just as each family and each business is unique, each succession plan is unique. To establish an effective business succession plan, an advisor must review a variety of planning techniques with the client, and often must integrate and customize various techniques to successfully accomplish the client's goals and minimize income taxes and transfer taxes. This outline provides an overview of the principal issues involved in: (i) transfers to key employees through equity and option planning and deferred compensation programs, (ii) transfers to co-owners through buy-sell agreements; (iii) transfers to family members through lifetime gifts and bequests, and (iv) transfers to family members through installment sales, sales to defective trusts, and GRATs. As appropriate, this outline and the discussion will address the issues involved in integrating certain techniques, the legal mechanisms to do so, and the applicable tax consequences.

I. EQUITY AND OPTION PLANNING

A. Initial Considerations

Business owners often consider transferring equity ownership in their business to key employees as both part of a compensation program and as part of their business succession plan. When transferring an ownership interest to an employee, a business owner must carefully consider various consequences, including legal consequences, tax consequences, and family consequences.

1. Legal Consequences.

From a legal perspective, the transfer will likely cause the business owner to owe fiduciary duties to such employee. Courts have long held that majority shareholders, like corporate officers and directors, owe a fiduciary duty of loyalty to minority shareholders that precludes them from using their positions as controlling shareholders to extract material economic benefits from the firm at the minority's expense. See *Jones v. H.F. Ahmanson & Co.*, 460 P.2d 464 (Cal. 1969).

2. Securities Laws.

The offer, award or sale of stock (or other ownership interest) is an offer or sale of securities that must be registered pursuant to the Securities Act of 1933, or be exempt from registration requirements. Generally, a transfer of securities by a closely held company to an employee is compensatory circumstances is exempt from registration under Rule 701. See 17 C.F.R. 230.508 (1997). Every state also regulates the offer and/or sale of a security to a resident, and a company offering an option or a share of stock to an employee or other service provider must take into consideration the "blue sky" laws of the state where the recipient resides. In California there is a limited exemption available for offers to a limited number of employees or services providers. See Cal. Corp. Code 25102(f); 25102(o).

3. Inspection Rights

A shareholder of a California corporation will have the absolute right to inspect the accounting books and records, and the shareholder and director minutes of the corporation. See California Corporations Code §§1600-1605. A similar absolute statutory right does not exist for owners of partnership or LLC interests under California law. For non-California corporations, the law of the incorporating state may apply to inspection rights, and such law will vary from state to state.

4. Tax Consequences.

Depending on how the business interest is transferred, income tax on the "fair market value" of the interest transferred may be immediate, deferred or avoided (see discussion below). From the employee's perspective, if the business entity is an S corporation, LLC, or partnership, ownership of an interest in the entity will cause the employee to be allocated a share of the entity's taxable income, and may create unintended cash flow burdens unless the entity distributes sufficient funds to pay the allocable taxes. See IRC §§1361-1379.

5. Family Consequences.

From a family perspective, the business owner must carefully consider placing restrictions on the employee's ability to further transfer such ownership interest, including providing the business (or other family members) a buy-back right in the event of the employee's death, disability

or termination. (See Section II below). Conversely, an employee may desire a right to “put” such interest to the family in such event.

B. Benefits of Equity and Option Planning

The ability to attract and retain key employees can be vital to the continuing success of a business. This is especially true when family members are not involved in the business and when a founder desires to transition out of the business. Equity and option plans can be the difference between retaining the business’s most talented employees during a time of transition, or losing such employees to a competitor. If structured properly, an equity or option plan can be a tax effective way to motivate key employees, reward performance, and tie key employees to the company for the long term.

C. Stock Grants.

1. Issuance.

   Under a stock grant program, the company or an owner would grant shares or membership interest (both referred to as “stock” or shares” throughout this section for convenience) outright to the employee, typically vesting permanent ownership of such stock in accordance with a schedule determined by the company. Stock grants offer the company significant flexibility, in that there are no statutory restrictions on the number of shares which can be granted to any person or on vesting schedules. Stock grants can vest over any schedule set by the company, and multiple grants may have serial and different vesting schedules.

2. Income Tax Treatment to Employee

   a. Vesting. Under IRC §83, the employee is generally treated as receiving compensation income as of each date that he becomes vested in the applicable shares. Under IRC §83, “vested” means that the shares are not subject to a substantial risk of forfeiture and are transferable.

   b. Substantial Risk of Forfeiture. Generally a substantial risk of forfeiture exists because the stock is subject to conditions similar to the following: (i) the shares revert to the employer on termination of employment without payment, or (ii) if shares were sold to the employer in connection with the performance of services, the employer has the right to repurchase such shares at the original purchase price upon employee’s termination. See Treas. Reg. §1.83-3(c).

c. Section 83(b) Election. Even though shares may not be transferable or may be subject to a substantial risk of forfeiture, an employee (with the consent of the employer) can file an election with the IRS under Code section 83(b) (a "section 83(b) election") to be taxed on the fair market value of all shares on the date of grant, rather than being taxed on a potentially higher amount as the shares vest. The advantage of the section 83(b) election is that appreciation from the date of the election until a later sale will be subject to the favorable capital gains tax rates. The employee should only make a section 83(b) election if he is reasonably confident that he will become vested in all the shares and that the shares will rise – not fall – in fair market value. Otherwise, he will be taxed on the full fair market value of the shares as of the date of grant and be left with a capital loss should the shares fail to vest or fall in value. A section 83(b) election must be filed with the IRS within 30 days of the transfer of stock, and an extension is not available. IRC §83(b)(2); Treas. Reg. § 1.83-2(b).

3. Tax Withholding

Because the shares constitute compensation income to the employee when they vest (or when they are granted, if the employee makes a section 83(b) election), the company must withhold income taxes, and withhold and pay Social Security taxes, on the shares just as if the company had paid cash compensation to the employee. See IRC §§3101, 3301. See also Rev. Rul. 67-257, 1967-2 C.B. 359. Employers ordinarily fulfill these obligations by withholding extra amounts from cash compensation to the employee in the same year in which the employee becomes taxable on the shares. This income tax obligation can be a serious burden for the employee.

Practice Point. The income tax burden associated with stock grants must be addressed when a closely held business owner is considering granting stock to employees– particularly if the stock has a high fair market value at the time of grant – because the individual must pay taxes as the shares vest, regardless of whether the shares can be freely sold. To ease the tax burden, a company may combine a stock grant plan with a loan or similar program to help the employee pay the taxes resulting from vesting or the making of a section 83(b) election.

D. Stock Option Plans.

Under a stock option plan, the company or owners would grant individuals the right to buy a specific number of shares for a specific price (the "exercise" or "strike" price). Options can either be "incentive stock options" or "non-qualified stock options," and a plan can provide for the grant of both non-qualified and

incentive stock options. In either case, optionees typically do not share in dividends or receive any credit for dividends paid until the option is actually exercised and the optionee becomes an actual shareholder.

1. Non-Qualified Stock Options

Non-qualified stock options (**"NQSOs"**) are more flexible than incentive stock options. They can be issued to employees or non-employees; there are no limits on the number of shares that can be optioned; they can vest over any schedule; and multiple options may have serial or different vesting schedules.

a. Income Tax Treatment. Upon grant of an NQSO, the optionee does not recognize income and the employer does not obtain a deduction. Upon exercise of an option, the optionee realizes compensation income equal to the difference between the exercise price of the option and the fair market value of the shares for which the option is exercised (the "spread"). Treas. Reg. §1.83-1(a)(1). The employer will be entitled to a deduction equal to the amount of ordinary income recognized by the optionee. Treas. Reg. §1.83-6(a)(1).

b. Basis. The optionee acquires a basis in the shares equal to their fair market value at the time the ordinary income is recognized. Treas. Reg. §1.83-4(b)(1). Additional appreciation after that point could qualify for capital gain treatment if the stock were retained for the requisite holding period, measured from that point onward.

c. Section 83(b) election. In the absence of a § 83(b) election, there would be no income recognition at the time of the exercise of options for unvested shares, but when the shares vested, there would be income recognition based upon the difference between the value of the stock at the time of vesting and the exercise price. On the other hand, if a § 83(b) election were made at the time of exercise, then there would be ordinary income recognition based upon the difference between the value of the stock at that time and the exercise price regardless of whether or not the shares are vested.

d. Tax withholding. Because the spread between the option price and the fair market value of the share constitutes compensation income to the optionee, the company must withhold income taxes, and withhold and pay Social Security taxes, on the spread just as if the company had paid cash compensation to the employee. As with stock grants, employers ordinarily fulfill these obligations by withholding extra amounts from cash compensation to the

employee in the same year in which the employee becomes taxable on the shares.

Practice Point. NQSOs are often more attractive to employees than are outright stock grants because the employee can time the exercise of an option and, therefore, the timing and amount of the tax burden imposed on such exercise. Nonetheless, the tax burden upon exercise can be substantial, especially when considered on top of the cash outlay that the employee must make to exercise the option in the first place. In the context of closely held businesses, many option holders leave their options unexercised until a sale of the company is imminent or the sale of the shares is otherwise possible. This avoids the need to finance the exercise price and income tax cost before the employee monetizes the interest by selling the stock. The downside of this strategy is that more (or all) of the appreciation from the time of the award until exercise will be treated as ordinary income as opposed to capital gain. Also, if the options expire prior to a sale, the employee may be hard-pressed to come up with the cash to pay the exercise price as well as taxes due.

2. Incentive Stock Options

Unlike NQSOs, incentive stock options (**"ISOs"**) must meet specific requirements set forth in IRC §§421, 422, and 424. ISOs *generally* present more favorable tax treatment for employee in that they can avoid a major detriment of NQSOs – namely, taxation of the employee upon exercise of an NQSO without commensurate receipt of cash to pay the tax. However, a deduction generally is not available from the employer's perspective.

a. Restrictions. There are numerous restrictions on ISOs which diminish their flexibility when compared to NQSOs. For example:

1) The grantee must be an employee. IRC §422(b)(1).

2) The exercise price of an ISO cannot be less that the fair market value of the stock as of the grant date. IRC §422(b)(4).

3) Of all options held by an optionee that become exercisable in the same calendar year, only the option covering the first $100,000 worth of stock qualify for ISO treatment. IRC §422(d). Any options in excess of this limit are treated as NQSOs.

4) ISOs cannot be exercisable more than 10 years after the grant date. IRC §422(b)(3). The maximum term is reduced to 5 years if the optionee owns more than 10% of the company's stock. IRC §422(b)(6).

b. Income Tax Treatment. For regular income tax purposes, the optionee does not realize any income upon the grant or exercise of the ISO and is entitled to long-term capital gain treatment for all of the profit on disposition of the shares, but only if the optionee has held the shares for more than 2 years after the date the ISO is granted and 1 year after the ISO is exercised. IRC §421(a)(1). In the case of a "non-qualifying disposition," however – *i.e.*, the employee sells or otherwise disposes of the shares either within 2 years after the ISO is granted or 1 year after the ISO is exercised – the optionee recognizes ordinary income to the extent of the spread as of the date of exercise and recognizes long-term or short-term capital gain on only the excess over the spread. IRC §§83(a), 421(b). That is, the employee is treated as if the ISO were an NQSO. In that case, the employer obtains the same deduction as for an NQSO.

c. AMT Trap. The tax treatment to the employee depends on whether the employee is subject only to the regular income tax or to the alternative minimum tax (the **"AMT"**). The AMT denies taxpayers the use of certain deductions otherwise available for regular income tax purposes or forces them to recognize income that is otherwise exempt for regular income tax purposes. IRC §55(a). Though originally targeted at "wealthy" individuals to force them to pay some tax each year, the AMT is not indexed for inflation and therefore is being imposed on more and more taxpayers each year.

1) For AMT purposes, the optionee does not realize income upon the grant of an ISO, but does recognize income upon exercise. IRC §56(b)(3). In other words, for AMT purposes, the exercise of an ISO is treated in a manner similar to the exercise of an NQSO.

2) If an employee is otherwise subject to the AMT (*e.g.*, because he/she has a large itemized deduction for state income taxes or other deductions that are denied for AMT purposes, or because the spread from the exercise of the ISO and other items increase the employee's income for AMT purposes even though these items are ignored for regular income tax purposes), the employee would be subject to tax on exercise without commensurate cash with which to pay the tax.

3) In the AMT context, the employee is subject to the tax even if the shares acquired pursuant to the option drop in value (*e.g.*, because the employees holds onto the shares for an

additional year in order to avoid a non-qualifying disposition). This AMT problem ensnared many employees of former "dot com" companies whose share prices plunged in 2000 after the ISOs were exercised.

Practice Point. While the elimination of income tax may cause ISOs to sound attractive at first glance, ISOs rarely work well in the context of a closely held family business due to the restrictions on stock value, the 10 or 5 year term maximum, and the lack of liquidity to deal with the AMT issue. If income taxation on the transfer of stock to an employee is a primary concern, a business owner should consider the techniques discussed in Section I.E and I.F below. Another idea worth consideration may be an installment sale of stock to the employee from the business owner. This may be especially tax advantageous for the employee if the business owner expects to sell the business and would like to reward a long-term employee with a share of the proceeds. For example, the business owner can sell a minority interest to the employee for a discounted fair market value, and the payment for such stock can be an installment sale with a balloon payment at the end of the term. If the company is sold during such term, the employee would receive his proportionate share of the purchase price, and after repayment of the promissory note, all gain will be capital gain taxable at the favorable capital gains tax rate. However, planners must ensure any discount be appropriate in light of the interest transferred (see Section III. C below) or there is a risk the discount could be disregarded and re-classified as income.

E. Partnership or LLC Interests

For a family business which is a partnership or LLC (that is taxed as a partnership), it is possible for the business owners to transfer capital interests in the partnership or LLC in a manner which is substantially similar to the transfer of stock as described in Sections B, C, and D above. However, partnership and LLCs are unique in that they provide the business owner an opportunity to transfer a "profits interests" to an employee, and such technique may offer a number of tax advantages over both corporate stock and partnership capital interests.

1. Profits Interest

    a. Non-Taxable Event. Receipt of a partnership profits interest in exchange for services provided to the partnership by a partner, or in anticipation of becoming a partner, is generally not a taxable event regardless of whether it is vested upon receipt. See *Campbell v. Comm'r*, 943 F2d 815 (8th Cir. 1991) (Court held the profits interest was not taxable because its fair market value was not

determinable due to the speculative nature of the revenue of the partnerships involved, and rejected a prior holding under analogous facts in *Diamond v. Comm'r*, 56 TC 530, *aff'd* 492 F2d 286 (7th Cir. 1974)).

b. Safe Harbor. In Revenue Procedure 93-27, the IRS stated that, if a person receives a profits interest for the provision of services to, or for the benefit of, the partnership in a partner capacity or in anticipation of being a partner, then the IRS will not treat the receipt of the interest as a taxable event. The "safe harbor" granted by Revenue Procedure 93-27 does not apply if the profits interest relates to a "substantially certain and predictable stream of income" from partnership assets, such as income from high quality bonds or net leases. The safe harbor also does not apply where the partner disposes of the profits interest within two years of receipt or if the interest is a limited partnership interest in a publicly traded partnership. Rev. Proc. 93-27, 1993-1 C.B. 343 and 2001-43, 2004-2 C.B. 191.

2. Capital Interest vs. Profits Interest

a. Generally, the distinguishing feature between a capital interest and a profits interest is the partner's right to a share of partnership capital or equity as it exists on the date of the issuance of the partnership interest.

b. In contrast to a profits interest, an interest in existing partnership capital issued as compensation for services is treated as income under IRC §61. Such income is taxed under IRC §83, which requires the employee to include in her gross income the excess of the fair market value of the capital interest over any amount paid for such interest.

c. For example, if an employee is issued a profit interest entitling him to receive 10 percent of the company's unascertainable future profits, losses, and distributions, but not a share of the existing capital, the employee will be treated as receiving a partnership profits interest. The tax advantages are: (i) the employee recognizes no income upon receipt of the ownership interest, and (ii) the employee will be eligible for capital gains tax treatment when the ownership interest is sold or liquidated (however, this may depend on the character of the assets held by the LLC or partnership).

Practice Point. For various reasons, LLCs are considered by many as the "entity of choice" for closely held family businesses. The ability to grant an employee a "profits interest" with no income tax implications in the same manner as a partnership certainly adds to their appeal. The LLC is also an extremely flexible entity. An LLC operating agreement can define the "profits interest" in any number of imaginative ways. For example, the value can be keyed to the profits from an employee's particular division; profits from a product line over which such employee has primary responsibility; gross sales in a territory over which such employee has primary responsibility; or similar factors.

3. Carried Interest

A vigorous political debate has been ongoing in connection with the use of profits interests as part of a compensation strategy for managers of hedge funds and private equity funds (sometimes also referred to as "carried interests"). Opponents argue that this strategy permits fund managers to report what is, arguably, compensation for services at capital gains tax rates instead of ordinary income rates.

a. Recent Proposed Legislation. In September 2011, President Obama introduced the American Jobs Act of 2011 to the Senate, which, in part, proposes to tax income and gain attributable to "investment services partnership interests" as ordinary income, subject to self-employment taxes S.1549 112th Cong., 1st Sess. (2011). Section 412 of the S.1549 defines investment service partnership interests as interests in an investment partnership acquired or held by any person in connection with such person's investment management services; namely, (a) advising as to the advisability of investing in, purchasing, or selling any specified asset, (b) managing, acquiring, or disposing of any specified asset, and (c) arranging financing with respect to acquiring specified assets. Such legislation, if enacted, would severely penalize the income attributable to a profits interest in certain types of entities.

b. Prior Proposed Legislation. The recent legislation is a departure from prior legislative proposals, which applied to all partnership interests and used a blended capital gain/ordinary income rate that was lower than the full ordinary income rate. See H.R. 4213 111th Cong., 2nd Sess. (2010). However, the proposed changes to the taxation of carried interests in H.R.4213 were strongly opposed and ultimately eliminated from the legislation before it was enacted by Congress, and similar opposition is expected to the carried interest provisions of S.1549.

F. Deferred Compensation

1. Nonqualified Deferred Compensation Plan

In some cases, a business owner may have a strong desire to not transfer ownership outside of the family; however, they may still wish to tie certain key employees to the business for the long term. In such cases, the business owner may consider establishing a nonqualified deferred compensation plan. Essentially, such a plan constitutes the business's unsecured promise to pay deferred compensation to an employee (or his or her designated beneficiaries) at a future date or on the occurrence of a specified event, such as the sale of the business or the death, disability, or retirement of such employee.

2. Phantom Stock or Stock Equivalency Units

Phantom stock is essentially unfunded deferred compensation that is based on changes in the value of the company's stock. Phantom stock plans often contemplate the granting of "stock equivalency units" ("SEUs") which can give an employee any combination of the economic benefits of owning stock – *e.g.*, the equivalent of participation in dividends, participation in the proceeds from a stock or asset sale, and/or the ability to "put" (*i.e.*, require the corporate employer to buy) units or SEUs at a price equivalent to the fair market value of a share of stock. Phantom plans can also provide for vesting of SEUs, and individuals can receive as many and as frequent awards of units or SEUs as the employer desires.

a. Tax treatment. The employee or other service provider is not taxed, and the employer is not entitled to a deduction, upon the issuance or vesting of a unit or SEU. Instead, the individual is taxed (and the employer receives a commensurate deduction) only if and when cash is paid to the individual pursuant to the terms of the unit or SEU. See *Martin v Commissioner* (1991) 96 TC 814, 830; Rev Rul. 80-300, 1980-2 Cum Bull 165. These payments are ordinary income to the individual, and – since they are additional compensation to the individual – income and Social Security taxes must be withheld and paid on such amounts if the individual is an employee. See IRC §404(a)(5).

b. Advantages of phantom stock plan. A major advantage of a phantom plan over a stock grant or option plan is that the employee does not face the risk of having "cash-less" taxable income – *i.e.*, taxable income upon the vesting of stock or exercise of an option

without the cash needed to pay the resulting taxes. Other advantages are as follows:

1) The formula used to value the units awarded can be unrelated to the value of the corporation, partnership or LLC. Instead, it may be more specifically tied to the individual's performance or duties. For example, the value can be keyed to the profits from an employee's particular division; profits from a product line over which such employee has primary responsibility; gross sales in a territory over which such employee has primary responsibility; or similar factors.

2) The plan can tie payouts to events unrelated to sale of the stock or assets of the corporation, such as retirement or fixed periods of years.

3) The plan can be tailored to different tasks, employment histories, goals, and similar factors applicable to a single employee or groups of employees.

Practice Point. The pay-out formula in the SEU may be varied to provide the employee or other service provider with whatever "net" tax results the employer desires. For example, a payment of $100, net of ordinary income tax, nets an employee approximately $59 in California (assuming maximum California and federal rates). A payment of $100 net of *capital gains taxes* nets the employee approximately $77 in California. A payment of $132 taxable as ordinary income also nets the employee about $77 after tax. In the latter case, the employer's net cost (after deducting the payment) is approximately 59% of the payment, or $77. If the owners of the employer had instead given the employee shares and the employee received a portion of the owners' capital gain, a $100 reduction of capital gain net of a 23% tax rate result in a net cost of about $77. In other words, the *economic* effect (net after tax) of a capital gain can be achieved for the employee without increasing the net after-tax cost to the owners.

G. IRC §409A

When implementing any of the planning described in Section I, planners must carefully consider the effects of IRC §409A. The American Jobs Creation Act of 2004 created IRC §409A to eliminate abuses related to election timing, distribution timing, and the ability to take accelerated payments under nonqualified retirement plans and other deferred compensation arrangements. IRC §409A provides generally that, unless certain requirements are met, amounts deferred under a nonqualified deferred compensation plan will be currently includible in income and subject to an additional 20% excise tax.

1. Definition of Deferred Compensation under IRC §409A

IRC §409A and the Treasury Regulations thereunder broadly define "deferred compensation" as any amount that vests in one year but is paid in a later year (with a few exceptions) to an individual or group of employees and nonemployees, such as independent contractors and directors.

2. Requirements with Respect to Election to Defer Compensation

Under IRC §409A, a deferred compensation arrangement must require that initial deferral elections be made before the taxable year in which compensation is earned, and the time and manner of later payment must be fixed at that time. New participants can make elections respecting unearned compensation within 30 days after first becoming eligible to participate. Deferral elections must be irrevocable for the year and cannot be changed except in limited circumstances.

3. Limitation on Time and Manner of Distributions

Under IRC §409A, amounts deferred may not be distributed earlier than: (i) the participant's separation from service, (ii) the participant's disability, (iii) the participant's death, (iv) a specified time (or fixed schedule) established at the time of the deferral, or (v) upon a change in the "actual or effective control" of the company.

4. Arrangements Exempt from Code 409A

The Treasury Regulations provide some exemptions from the restrictions under Code §409A, as long as various conditions set forth in the regulations are strictly met. Arrangements that are generally exempt include compensation payable within two and a half months after the year in which it vests; restricted stock; stock-option and stock-appreciation rights in which value is determined in a manner consistent with the regulations; and capital or profits interests on LLC or partnership.

II. BUY-SELL AGREEMENTS

Generally, co-owners of a business will enter into a buy-sell agreement to govern the purchase or sale of business interests upon the occurrence of events such as disability, marital dissolution, bankruptcy and, of course, death.

A. Objectives of Buy-Sell Agreements

A buy-sell agreement, whether drafted as a separate agreement or incorporated into a shareholders agreement, partnership agreement or LLC operating agreement, is used to govern the relations of co-owners and to address many different issues or objectives. The following are examples of some of the issues that must be considered when drafting a buy-sell agreement:

- Determining when a buy-out right/obligation should be triggered (*e.g.,* disability, marital dissolution, bankruptcy, death.)
- Determining whether such buy-out should be mandatory or optional. Note that mandatory purchase obligation held by a corporation may be set aside if the corporation is insolvent. See Cal. Corp. Code 500.
- Establishing the value of a business interest for buy-out purposes and estate tax purposes in the event of death;
- Determining the payment terms for the buy-out and providing the funding;
- Establishing guidelines for transfers of ownership to existing owners and family members;
- Determining if there should be restrictions on transfer to outside parties;
- Defining the rights of family members or different families who co-own a business;
- Providing for management succession and governance arrangements, including control and compensation for family members who actively participate in the business; and
- Providing protections for family members who do actively participate in the business, such as required distributions of available cash flow and "put" rights.

B. Determination of Buy-Out Price

One critical feature of the buy-sell agreement is the provision which establishes the price at which the business equity will transfer upon the occurrence of a triggering event. The buy-out price may vary depending upon the circumstances. For example, an owner who is voluntarily withdrawing before reaching retirement age may be required to sell his or her equity to the other owners or the business at

a lower price than his or her estate would be required to sell such equity at his or her death. Below are some common approaches used to establish value.

1. Certificate of Agreed Value

A buy-out price can be established by a pre-determined agreement among the business owners; provided, however, such agreement should be renewed on a periodic basis (e.g., annually) and should be evidenced by the owners executing a certificate that is attached to the buy-sell agreement. This approach, if kept current, is a good way to determine the value of the entity as it reflects an agreed value when the parties do not know whether they will be a buyer or seller. To address the possibility that the owners will not update the agreed value to keep it current, an adjustment provision may be incorporated to provide for automatic adjustments, at designated intervals, in the agreed value based upon a stated percentage increase, the performance of the business during the prior year or other factors. Alternatively, the agreement can provide that the agreed value will lapse if not updated and the value can be determined by a formula provision or an appraisal.

2. Formula

A buy-out price can be established by a formula provision within the buy-sell agreement. The formula can be based on a variety of metrics, such as adjusted net book value, net cash flow, gross revenue, net earnings or EBITDA, or a multiple of one of the foregoing. The multiple is ordinarily determined by examining the appropriate ratio for comparable companies which have recently sold or whose stock is publicly traded. The formula language may include a variety of terms and can include various adjustments in various contexts. The buy-sell agreement should define all terms and adjustments with precision, so that the parties understand their meaning within the context of the buy-sell agreement.

3. Appraisal

A buy-out agreement can also provide that the buy-out price will be determined by an appraisal obtained by the parties following the occurrence of a triggering event. The agreement can provide, among other choices: (1) for valuation by a designated appraiser, or the certified public accountant, trusted by the parties; (2) that the owners mutually select an appraiser; or (3) if the owners cannot agree on an appraiser, each owner obtain a separate appraisal, and then the average of the values is used. If the appraisal method is used, the buy-sell agreement should address whether the appraiser should take into account factors such as minority and marketability discounts, control premiums and goodwill. In addition,

if the parties can agree, it is beneficial for the buy-sell agreement to specify the type of valuation methodology that the owners believe to be most reflective of the industry and most appropriate for use in preparing the appraisal.

4. Payment Terms

Because many companies do not have sufficient cash on hand to immediately fund a buy-out, co-owners should carefully consider the buy-out terms within the buy-sell agreement. Co-owners will often agree to provide installment payments in the buy-out agreement, with promissory notes given by the company or the remaining co-owners with a market rate of interest. If the company is the obligor under the note, the co-owners may desire a personal guaranty from the remaining co-owners or other security to mitigate the risk associated with the deferred payment. From the remaining co-owners' perspective, they may want to ensure that the buy-out payments do not become too burdensome on the company during a difficult year, and the co-owners may agree to a cap (tied to a percentage of net profit or revenue) on the buy-out payment in each applicable year.

C. Buy-Out Price and Estate Tax

Due to the flexibility that business owners have in determining the buy-out price in a buy-sell agreement, planners must note that the valuation established by a buy-sell agreement will not automatically be respected to establish value for estate tax purposes. In order to establish the value for estate tax purposes, the IRS requires that the buy-out price reflect the fair market value of the applicable interest, taking into account the restrictions set forth in the buy-sell agreement and other relevant factors. See IRC §2031; Treas. Regs. §20.2031-1(b). Discounts due to a restrictive buy-sell agreement will only be accepted by the IRS if the following factors are present:

- The right or restriction must be a bona fide business arrangement;
- The right or restriction must not be a device to transfer property to members of the decedent's family for less than full and adequate consideration in money or money's worth; and
- The terms of the right or restriction must be comparable to similar arrangements entered into by persons in an arm's length transaction.

D. Buy-Sell Agreements and Life Insurance

1. Insurance to Fund Buy-Out

If the company or co-owners intend to maintain life insurance to fund a buy-out upon death, the owners may desire to use the applicable policy's death benefit as a "floor" to buy-out price. This will ensure that the deceased owner's heirs receive the entire death benefit of the applicable insurance policy regardless of the formula value or appraised value of the company on the date of death.

2. Insurance Planning

Coordination of the life insurance component of the business owner's estate plan and the buy-sell agreement is essential, because of the disparate estate tax consequences of (i) a co-owner's family receiving insurance proceeds in connection with the buy-out of the deceased co-owner's interest in the business (such proceeds will generally be included in the deceased's estate and subject to estate tax), and (ii) a co-owner's family receiving insurance proceeds from a policy owned by an irrevocable life insurance trust (such proceeds will be outside of the deceased's estate and not subject to estate tax).

3. Irrevocable Life Insurance Trusts

An irrevocable life insurance trust ("ILIT") is designed to own life insurance on the grantor's life in order to remove the value of the policy from the grantor's taxable estate.

a. Generally, life insurance proceeds are includable in the taxable estate of the insured if the insured retains any incidents of ownership over the policy, such as the right to borrow the cash value of the policy, change the beneficiaries, cancel the policy or change how the proceeds are ultimately distributed. See IRC §2042; Treas. Regs. 20.2042-1(c)(2).

b. When an ILIT is the owner and beneficiary of a policy, the insurance policy is held in trust for the beneficiaries by a third-party trustee. Thus, the grantor does not maintain any of the above described incidents of ownership, and the insurance proceeds will be outside of the grantor's estate. *See* Rev. Rul. 84-179, 1984-2 Cum Bull 195; Rev Rul 95-58, 1995-1 C.B. 191; Treas. Reg. 20.2036-1(b)(3).

c. Generally, the grantor will make annual cash gifts to the ILIT in an amount sufficient to pay the applicable insurance premium. In many cases, such gifts can be made in a manner that will qualify for the annual gift exclusion (see Section III.B.1).

d. To ensure that all transfers to the ILIT qualify as gifts, the ILIT typically provides each beneficiary of the trust with the power to withdraw gifts for a period of 30 dates from the date of receipt. This is referred to as a *Crummey* power, after the famous case, *Crummey v. Comm'r,* 397 F2d 82 (9th Cir. 1968). Once the period in *Crummey* provision (usually 30 days) has expired without exercise of the withdraw right, the trustee may use the funds to pay the premiums.

Practice Point. For co-owners employed by the business, life insurance policies can be used to fund buy-outs, as an employee benefit, or a combination of such purposes. In such cases, there may be a significant opportunity to reduce estate tax by (i) establishing a buy-out price under IRC §2031 for the applicable business interest, (ii) using some life insurance to fund the buy-out, and (iii) distributing cash to the co-owners as compensation so that they may maintain additional life insurance in an ILIT for the benefit of their heirs.

E. Type of Buy-Sell Arrangements

A buy-out can be structured as a redemption by the company or a cross-purchase by the co-owners, and planners must consider the tax consequences of each structure.

1. Redemptions

a. Life insurance policies on owners can be owned by the company, and upon a death, the death benefit may be received by the company free of income tax. Upon receipt of such proceeds, the company can apply all or a portion of such proceeds to redeem the deceased owner's ownership interest. Note that the company will get no deduction for insurance premium payments.

b. In the redemption structure, there are several income and estate tax consequences that the owners must consider. First, the life insurance may increase the value of a business on the death of the insured, and the buy-out price must take this increase into account or value the business before the triggering event so that only the interpolated terminal reserve value of the policy is included in the valuation. Second, since the company is redeeming the interest, if

the company is a corporation, each co-owner's basis in the interest they hold will not increase in the same manner as if the co-owner bought the interest directly from the deceased co-owner.

2. Cross-Purchase

   a. A cross-purchase agreement may also be used and funded by life insurance owned by the individual co-owners. Upon a death, the surviving co-owners will receive the insurance proceeds free of income tax, and can apply such proceeds to acquire the deceased owner's interest. Each purchasing co-owner will receive a basis in the interest he or she acquires equal to the purchase price.

   b. A cross-purchase agreement does not affect the value of the company for estate tax purposes, but may nevertheless result in some inequality among the co-owners, as the cost of the insurance is borne by the purchaser, not the company. Generally, salary adjustments or other mechanisms may be used to correct an inequality.

   c. Note that the premiums paid by the shareholders will not be deductible for income tax purposes, whereas additional compensation paid to an employee as a fringe benefit so that such employee can purchase insurance will generally be deductible to the company. See IRC §162.

   d. Cross-purchase life insurance may become cumbersome when there are many co-owners. This complexity may be reduced by using a trustee to hold life insurance. The trustee in this situation is similar to an escrow holder, who ensures that the insurance proceeds are used to purchase the business interests of the deceased co-owner on behalf of the remaining co-owners.

Practice Point. Planners may consider a "wait and see" clause in the buy-sell agreements which essentially provides that the entity has an option to purchase the ownership interest of the withdrawing or deceased owner, but if such option is not exercised the option or obligation passes to the remaining owners. This will provide the entity and remaining owners additional flexibility when dealing with income tax consequences.

F. Buy-Sell Agreements and Marital Agreements

1. Marital Agreements

If a business is, in whole or in part, the separate property of one spouse, a marital agreement should be considered to clarify the character of each spouse's interest. The property rights of spouses may be altered by either a premarital agreement or a post-marital agreement. See Cal. Family Code §§850, 1500. Such agreement should contemplate the following:

a. For a business which was established prior to marriage, the marital agreement should specify whether the business is intended to remain separate property or transmuted to community property.

b. If the business grows during marriage, the marital agreement should specify whether the increased value will be considered separate property or community property.

c. On death, disability, or divorce, the marital agreement should provide direction on who will maintain control over management of the business.

Practice Point. A marital agreement may be especially advisable when there are children from a previous marriage to whom the business owner wants to transfer the business. If a marital agreement is not executed, yet husband and wife clearly intend for the business interest to remain separate property, it is prudent to include as an exhibit to the buy-sell agreement a statement, signed by the applicable spouse, acknowledging that the applicable spouse does not have a community property or other interest in the business interest. Regardless of the nature of the property at the time the buy-sell agreement is signed, it is also prudent to include buy-out provisions in the event of dissolution of a marriage. These provisions typically provide that if a spouse is granted a portion of the business interest in connection with the dissolution of a marriage, the divorcing co-owner shall have the first right to purchase such interest, and if such co-owner fails to purchase such interest, the company or other co-owners will have a right to purchase such interest.

2. Community Property

Under California law, each spouse owns an undivided one-half interest in all community property. Note that IRC §1014(b)(6) provides a step-up in the basis of both halves of property owned by a husband and wife as community property on the date of the death of the first spouse to die.

3. Value of Business Interest in Event of Divorce

Business owners should be aware that buy-sell agreements have been considered in marital actions to fix the value of business interests for purposes of property division. See *Marriage of Iredale & Cates* (2004) 121 CA4th 321. However, although courts have found such agreements relevant to determining value, they are not typically the deciding factor. If an agreement does not expressly provide that the valuation was intended to apply in marital dissolution proceeding, courts have held that the agreement was not binding and did not limit a trial court's discretion in a marital dissolution.

G. Buy-Sell Agreements and Marital Trusts

1. Marital Deduction Requirements

In certain cases, a business owner may desire to leave all or a portion of his or her interest in the business in trust for his or her spouse. The unlimited marital deduction provides that a decedent can leave an unlimited amount to his or her surviving spouse estate tax free.

2. Marital Trusts

The unlimited marital deduction will also apply to all interests left to the surviving spouse in either a marital deduction trust (IRC §2056(b)(5)) or a qualified terminable interest property (QTIP) trust (IRC §2056(b)(7)). Both trusts must contain specific provisions to qualify for the marital deduction.

a. Marital Deduction Trust. The marital deduction trust must provide that (i) all trust income must be payable to the surviving spouse, (ii) only the surviving spouse can be a beneficiary of the trust, and (iii) the surviving spouse must be given a general power of appointment, exercisable in all events, in favor of the surviving spouse or his or her estate.

b. QTIP Trust. In the case of the more restrictive QTIP trust, the decedent can control the ultimate disposition of the business interest distributed to the QTIP. To qualify for the marital deduction, a QTIP trust must provide (i) all trust income must be payable to the surviving spouse, (iii) only the surviving spouse can be a beneficiary of the trust, and (iv) the trustor must make an irrevocable election to treat the trust as a QTIP trust. If a trust fails to qualify as a marital trust or QTIP trust, a business interest

passing to such trust will be includable in the decedent's estate for federal estate tax purposes.

Practice Point. Planners must be careful to ensure that the provisions of the buy-sell agreement do not have the potential to cause a marital trust or QTIP trust to fail to qualify under the marital deduction rules. There are several Letter Rulings that indicate if a buy-sell agreement contains a provision allowing a third party to purchase a business interest at a price below fair market value, such provision may be a power of appointment in the third party over the applicable business interest. See Letter Rulings 9139001, 9147065. In addition, while the trust instrument may express the trustor's desire that the marital trust continue to hold a business interest for the spouse, the marital trust should not strictly prohibit the surviving spouse from requiring the trustee to convert the business interest into income-producing property.

3. Remainder Purchase Marital Trust

One planning idea which combines Marital Trust planning with certain elements of GRAT planning (See Section IV. D. below) is the Remainder Purchase Marital Trust, sometimes referred to as an "RPM Trust." In the context of a business owner, this technique would involve the business owner transferring an interest in the business to a trust for his spouse, with the spouse provided an income or annuity interest for a specified term or life, and a concurrent sale of the remainder interest to a trust for children or grandchildren (the "Remainderman Trust"). At the death of the spouse (or conclusion of the term), the assets within the RPM Trust will be owned by the Remainderman Trust, and will have effectively passed from the business owner and his spouse to the children (or grandchildren) estate tax free.

a. The transfer to the RPM Trust and Remainderman Trust is gift tax free because (i) the spouse's income or annuity interest in the RPM qualifies for the gift tax marital deduction, and (ii) the Remainderman Trust pays the donor the actuarial value of the remainder interest when the RPM Trust is created.

b. The RPM Trust assets should not be included in either the original business owner's estate (he has no retained interest) or the spouse's estate (the spouse does not have a general power of appointment and there is no QTIP election), and should ultimately pass to the children/grandchildren estate tax free. It is critical that the Remainderman Trust pay full consideration at the time of the RPM Trust creation, since IRC §2523(b)(1) provides that no gift or marital deduction is allowed if the spouse receives a life estate or

other interest in a trust and upon termination of the trust the trust assets pass to someone else "for less than adequate and full consideration.

H. Buy-Sell Agreements and Bank Loans

If a company maintains bank loans or lines of credit which are essential to its operation, coordination of the applicable loan documents and the buy-sell agreement is essential to a smooth transfer of ownership upon the triggering of a purchase under the buy-sell agreement. In many cases, the initial draft of loan documents will include restrictions which would disrupt or prevent the transfers contemplated under the buy-sell agreement. Business owners with buy-sell agreements in place must carefully review the terms of all loan agreements, and generally:

- Avoid provisions which would prohibit the company from distributing cash to a shareholder pursuant to a redemption under a buy-sell agreement;
- Avoid provisions which would cause a loan to become immediately due and payable upon the death of a shareholder; and
- Avoid provisions which would define an "event of default" as the death, disability, or retirement of a shareholder.

III. LIFETIME GIFTS AND BEQUESTS

A. Lifetime Gifts

If a business owner ultimately plans to transfer his business interest to his children, such owner should consider a lifetime gifting program sooner rather than later. Such an approach to transferring business interests may be a simple and tax-efficient way to move such assets to appropriate members of the second generation or to a trust for their benefit. If the owner desires to gift business value but not control, restructuring the company to create voting and non-voting interests can often accomplish such goal.

B. Gifting Capacity

1. Annual Exclusion Gifts

    a. Substantial reductions in estate tax can be achieved through the well planned use of annual gifts. Annual gifts within the federal annual gift tax exclusion (currently $13,000 per person, or $26,000 per couple, to any person) reduce the value of the donor's estate by

removing the value of the gifted property, as well as the amount of any post-gift appreciation on such property. See IRC §2503(b).

b. For example, if a couple has 3 children, they can gift $78,000 ($26,000 x 3) of value to the children each year. If the discounted value of the business is $5 million, they can gift over 1.5% of the ownership interest per year to their children. Note that the annual gift tax exclusion is "use it or lose," and any unused annual exclusion does not carry over to the next calendar year. Note also that unlimited gifts for medical and educational expenses can be made in addition to the $13,000 annual gift tax exclusion and without reducing the unified gift and estate tax exemption.

Practice Point. When completing gifts of interests in closely held businesses, planners must be mindful of IRC §2036(b) and how it can frustrate such planning. Section 2036(b) includes in the donor's estate the value of the stock of a "controlled corporation." Under IRC §2036(b) a corporation is deemed to be a controlled corporation if the donor retains, either directly, or through the attribution rules of IRC §318, the right to vote at least 20% of the voting stock. The attribution rules of IRC §318 deem a donor to be able to vote any stock that is owned by certain family members, such as a spouse, a parent, a child, or a grandchild. Note that Section 2036(b) will not apply to a transfer for full and adequate consideration, and will not apply to a gift of non-voting stock. See Rev. Rul. 81-15, 1981-1 CB 457.

2. Unified Gift and Estate Tax Exemption

a. With respect to gifts that do not qualify under the annual exclusion described above, current law (2012) provides a $5.12 million per person ($10.24 million per couple) unified gift and estate tax exemption. Thus, during one's lifetime, each individual can gift of $5.12 million before gift tax is due. IRC §2010(c)(3)(B); See also IR-2011-104 (Oct. 20, 2011); Rev. Proc. 2011-52 (Nov. 7, 2011).

b. Although such gifts will reduce the amount of estate tax exemption available upon death, there are compelling reasons to consider large gifts during lifetime, including: (i) uncertainty regarding whether or not this exemption will remain in place at these levels (see below), (ii) post-gift appreciation will occur outside of the donor's estate, and (iii) income generated by the gifted property can accumulate outside the donor's estate.

Practice Point. When planning gifts or other estate tax planning techniques for elderly married couples, the planner must consider the

adjusted tax basis of the property to be transferred. In the case of low basis property, there may be a compelling argument to not complete the transfer until after the first death so the surviving spouse and the heirs will enjoy a stepped-up basis on such property. See IRC §1014(b)(6). Conversely, lifetime transfers of low basis property may be desirable depending on the age of the donor and his spouse, the size of the estate, the nature of the property, the anticipated holding period of the property, and many other factors.

c. The law implementing the above unified gift and estate tax exemption, the Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act, was signed into law by President Obama on December 17, 2010. This law provided sweeping changes to the rules governing federal estate taxes, gift taxes and generation-skipping transfer taxes, but only for the 2010, 2011 and 2012 tax years. If this law expires without new legislation, the exemption will return to $1 million per person. See 124 Stat. 3296, 3304, §304 (2010) (applying the sunset provision of the Economic Growth and Tax Relief Reconciliation Act of 2001 to the 2010 Act); see also Economic Growth and Tax Relief Reconciliation Act of 2001, Pub. L. no. 107-16, 115 Stat. 38, §901(a)(2) (2001).

d. President Obama's 2012 budget proposal, introduced in February 2011, proposes to return the estate and gift tax rates to 2009 levels, meaning a $3.5 million estate tax exemption, $1 million lifetime gift tax exemption, and estate and gift tax rate of 45%. *Budget of the United States Government, Fiscal Year 2012*, February 14, 2011, available at http://www.whitehouse.gov/omb/budget.

e. Amid rumors of a call for an early reduction of the current $5 million estate and gift tax exemption amounts, Reps. James McDermott and Charles Rangel introduced the "Sensible Estate Tax Act of 2011" to the House on November 17, 2011. H.R.3467 112th Cong. 1st Sess. (2011). This legislation proposes to bring back the $1 million estate tax exemption and 55% estate tax rate. The bill would also coordinate the gift tax exemption with the estate tax exemption, bringing it back down to $1 million. *Stay tuned….*

C. Valuing Gifted Interest: Defining Transferred Interest and Discounting

1. Selecting the Appropriate Entity

A variety of business and tax factors must be considered when selecting the appropriate entity for the family business. Whether business and tax

considerations call for an LLC, limited partnership, C corporation or S corporation, gift and estate tax savings can often be achieved by gifting a discounted partial interest in the applicable entity to the next generation. If the transferred interest is non-controlling, the transfer of such interest can often be valued at a significant discount for gift tax purposes. Such discount may be enhanced if such interest is subject to significant restrictions on transfer. Such restrictions may be set forth in the business's buy-sell agreement (see Section II). In short, gifting discounted partial interests in the business allows a greater interest to be gifted with less tax consequence.

2. Factors Impacting the Discount

The factors influencing the level of a discount on a partial interest in a closely held business are based on considerations from the perspective of the investor. The following restrictions will generally enhance the available discount:

- Restrictions on or elimination of voting rights
- Restrictions on transfer
- Restrictions on access to information
- Restrictions on the ability to withdraw from the entity
- Restrictions on distributions

The Internal Revenue Manual (IRM) advises the agent to consider all factors listed above, as well as the nature and history of the business, and the business's economic outlook and financial condition, when valuing an interest in a closely held partnership or corporation and determining an appropriate discount. See Rev. Rul. 59-60, 1959-1 CB 237, modified by Rev. Rul. 65-193, 1965-2 CB 370, and amplified by Rev. Rul. 77-287, 1977-2 CB 319, Rev. Rul. 80-213, 1980-2, CB 101, and Rev. Rul. 83-120, 1983-2, CB 170 (these rulings are often considered by valuation experts as the definitive source outlining the standard of value, approach, methods, and factors to be considered in valuing an interest in a closely held business entity).

3. Precedent on Discounting

There is substantial legal precedent supporting the application of lack-of-control discounts and the lack-of-marketability in connection with the valuation of an interest in family business entities. Court decisions

allowing discounts of between 30% and 45% are common, and larger discounts are not unheard of. For varying judicial perspectives, *see e.g, Jones v. Comm'r* 116 TC 121 (2001); *Knight v Comm'r*, 115 TC 506 (2000); *Estate of Goodley v. Comm'r*, TC Memo. 200-242 (2000); *Moore v. Comm'r*, TC Memo. 1991-546 (1991).

4. Documenting the Discount

Notwithstanding the long line of precedent on "acceptable" discounts, the taxpayer has the burden of validating the amount of the discount. See *Estate of Edgar A. Berg,* TC Memo 1991-279 (8th Cir 1992) 976 F2d 1163. Thus, the taxpayer should engage a qualified expert to value the business interest and substantiate any discounts. The valuation and "discount study" must address and document the particular facts effecting the applicable business interest, and should not merely rely on previous cases to establish the amount of discounts. While the IRS is not bound to accept the opinion of the taxpayer's expert, for practical purposes, the presence of a valuation report by a qualified expert is critical in meeting an IRS challenge.

D. Timing of Gifts

From a gift tax perspective, the best time to transfer an interest in a business to a descendant or to a trust for descendants is when the business is worth the "least." After the transfer, all appreciation arises in the hands of the transferee and outside of the estate of the transferor. Generally, the business is worth the "least" at the time it is created or during difficult economic times. Therefore, the best time to implement a gifting program may be at times clients are least focused on such planning, such as when the business is first created, or when the economy or business is struggling.

IV. INTALLMENT SALES; DEFECTIVE TRUSTS, AND GRATS

A. Installment Sale

1. Sale to Third Parties

In a typical installment sale to a third party, the business owner sells the business or a business interest at its fair market value in exchange for an appropriate down payment and a secured promissory note bearing a market rate of interest. The sale of the interest will be taxable event, the business owner will be taxed on any gain recognized due to the sale, and the third party will receive a basis in the interest equal to his purchase price.

2. Sale to Family Members

a. Business owner can transfer business interests to family members via installment sales with no gift tax consequences. Selling a business interest in exchange for an installment note will remove post-sale appreciation from the seller's estate. Note that unless the sale is structured as a sale to an IDGT (see IV. B. 3 below), the sale of the interest will be a taxable event, and the business owner will be taxed on any gain as payments are received. In addition, the interest paid on the note will be taxable income.

b. In a typical installment sale to a family member, the business owner sells the business interest at its fair market value in exchange for an appropriate down payment and a promissory note bearing interest at the lowest rate that can be used without giving rise to imputed interest under IRC §7872. See also IRC 1274. This rate, known as the applicable federal rate, is currently at historical lows. For example, in December 2011 the applicable federal rate for a nine year promissory note is 1.27%. Rev. Rul. 2011-31.

c. If a seller dies before the note is paid in full, the then value of the note (determined with reference to the unpaid balance on the installment note and the note's stated interest rate) is includible in his or her estate for federal estate tax purposes. In some case, it may be possible to discount the face value of the note for federal estate tax purposes. See generally Treas. Reg. §20.2031-4; Treas. Reg. § 25.2512-4.

B. Installment Sale to an Intentionally Defective Grantor Trust

The sale of assets to an intentionally defective grantor trust ("IDGT") is an estate planning technique used to freeze the value of certain assets for estate tax purposes (*i.e.*, assets sold to an IDGT will be deemed to be outside the grantor's estate). The IDGT is drafted to include a purposeful "defect" that ensures that the income tax laws will not recognize that assets have been transferred away from the grantor.

1. Creation of Defective Trust

An IDGT can be created by drafting a standard irrevocable trust for children or grandchildren with provisions that intentionally violate one or

more of the grantor trust rules in Sections 671-679 of the Code. Generally, the IDGT achieves grantor trust status through the grantor's retention of certain administrative powers over the trust's assets, such as providing the grantor the ability to reacquire the trust assets by substituting other property of equivalent value.

2. Mechanics of Sale

Generally, the grantor initiates the sale by first "seeding" the IDGT with a cash gift large enough to be considered a reasonable down payment for the sale transaction. This initial funding of the IDGT will be a taxable gift which will count against the grantor's lifetime gift tax exemption. Next, the grantor sells the business interest to the IDGT in exchange for a down payment (equal to the amount of the earlier cash gift) and a promissory note for the remaining purchase price with interest at the applicable federal rate.

Practice Point. There is no legal authority that provides what size down payment will establish that the sale to an IDGT is in fact an "arms-length" sale. Letter Ruling 9535026 indicated that a 10% down payment was sufficient in one particular set of facts, but it may not be sufficient in all cases. With the current $5.12 million lifetime gift tax exemption, in many cases it is possible to "gift" a larger down payment without triggering gift tax. However, planners should strongly consider preserving some of the client's gift tax capacity when possible, especially in cases where the valuation or discount may be challenged, and if a portion of the sale may be reclassified as a gift.

3. Taxation of Defective Trust

Assets transferred to an IDGT will be deemed to be outside the grantor's estate for estate tax purposes, but the IDGT will be disregarded as a separate entity and treated as the grantor's "alter ego" for income tax purposes. Because of the IDGT's grantor trust status, the sale will be ignored for income tax purposes, and there will be no taxable gain on the sale or interest income from the promissory note. See Rev. Rul. 85-13, 1985-1, CB 184.

Practice Point. The grantor has the opportunity to further reduce his or her taxable estate by paying such income tax on the taxable income attributable to the IDGT-owned assets from assets outside the IDGT and allowing income from the transferred assets to accumulate within the IDGT. Effectively, the payment of the tax on IDGT income by the grantor is a tax-free gift to the beneficiaries of the IDGT. Note the IRS attempted to treat the payment by the grantor of income tax for a defective trust for

children as a gift in Letter Ruling 944003, but quickly reversed its position in Letter Ruling 9543049. For flexibility, a planner may want to include a provision in the IDGT that permits, but does not require, that the trustee directly pay income taxes on the IDGT income. Note that the IRS has ruled privately that a trustee's payment of income taxes imposed on a grantor under the grantor trust rules is not a retained beneficial enjoyment under IRC §2036. See Letter Ruling 199922062.

4. Tax Reporting of IDGT's Income.

All income attributed to the business interest held in the IDGT will flow through to the grantor's tax return, and must be reported as income on the tax return of the grantor. Treas. Reg. §1.671-4.

Practice Point. There is some debate about whether filing a separate tax return for the IDGT is beneficial. Treas. Reg. §1.671-4(b)(2)(ii)(B) indicates that such a return is not required. If filed, the tax return simply indicates that the trust is a grantor trust and all items will be reported on the grantor's return. Aside from the administrative burden, there appears to be no downside to such filing, and such record keeping can only help in the event is the IDGT is challenged for estate tax purposes by the IRS under IRC §2036 or some other basis.

5. Switching Off Grantor Trust Status.

Typically, the IDGT will include a provision which provides the trustor (or other powerholder) a one-time right to "switch-off" grantor trust status by relinquishing the applicable administrative power over the trust's assets, such as relinquishing the power to reacquire the trust assets by substituting other property of equivalent value. The loss of grantor trust status will cause the IDGT to be immediately treated as a separate taxpayer.

Practice Point. The election to terminate grantor trust status during the lifetime of the grantor may have numerous adverse tax consequences. For example, if an installment sale has been made to the IDGT, the payments from the IDGT to the grantor will no longer be tax free, and the associated interest income will also become taxable. Other serious adverse consequences can result under IRC §453. For example, if the installment obligation exceeds $5 million (or $10 million for married couples), the grantor may be required to pay interest on the deferred tax liability. See Tech Advice 9853002. Also, installment reporting may not be available under IRC §453 if the assets transferred are deemed to be dealer property or depreciable property.

6. Death of Grantor

Upon the grantor's death, the grantor status of the IDGT terminates. The grantor need not outlive the term of the installment obligation to obtain estate planning benefits, as the trust property, apart from the installment note, will be excluded from his estate. If the grantor dies before the repayment of the note, the remaining balance of the note becomes a part of the grantor's taxable estate. Under some circumstances, it may be possible to discount the face value of such note. See Treas. Reg. § 20.2031-4; Treas. Reg. §25.2512-4.

7. Basis Issues and the Negative Basis Problem

a. The basis issues relating to intra-family, deferred payment sale techniques are complicated because the separate tax regimes have inevitable overlap, such as the step-up in basis at death under IRC §1014 and the treatment of gifts under IRC §102 and 1015.

b. Upon the death of the grantor, the IDGT converts to a non-grantor trust, and the trust is a separate taxpayer for income tax purposes. There is no clear authority that addresses what happens to the basis of the assets held by an IDGT upon the grantor's death. This creates a gray area with respect to the basis of such property after death of the grantor.

c. The most logical result is that the conversion to a non-grantor trust upon the death of the owner occurs with the death of the owner, and the sale is deemed to come into income tax existence at that time. If this approach is applied, the trust should take a cost basis in the asset equal to the principal amount of the note.

d. This gray area described above is especially troublesome when the trust holds encumbered property with debt in excess of basis, sometimes referred to as "negative basis" property. If the IRS takes the position that the termination of grantor trust status due to the grantor's death is a recognition event, there is a potential for income tax recognition in these "negative basis" cases. However, the income tax law has long viewed death as not a recognition event for income tax purposes. See Rev. Rul. 73-1, CB 364; Rev. Rul. 85-13, CB 184.

e. There is a colorable argument that the beneficiaries of an IDGT will receive a step-up in the basis of the assets owned by the IDGT

based on IRC §1014(b)(1), which states that all properties acquired from a decedent by a bequest or devise receive a step-up in basis. However, it appears to be more likely that the IRS will likely take the position that the assets were acquired by the IDGT via the sale, and not a bequest or devise, and therefore §1014(b)(1) should not apply.

f. It is also be possible for an IDGT to convert to a non-grantor trust upon the grantor's election during the grantor's lifetime (see Section III. B. 4 above). In such cases, planners must be especially careful about "negative basis" property. If such a termination is deemed to be a "recognition event," the IRS can reasonably take the position that the amount by which debt exceeds basis must be reported as taxable gain. See *Madorin v. Commissioner*, Rev. Rul. 77-402 and Treas. Reg. § 1.1001-2(c).

Practice Point. The transfer of assets to an IDGT should focus on assets with the least need for a step-up in basis and the greatest potential for future appreciation. In the case of an IDGT that does hold low-basis or negative basis assets, planners should monitor such IDGT and strongly consider "substituting out" low-basis assets for cash or cash equivalents within the client's taxable estate if the client is close to death and the step-up in basis would be valuable to the heirs.

C. GRATS

A GRAT is another technique which allows a business owner to transfer business interest to family members with no or minimal gift tax consequences while reducing estate tax and receiving a steady cash flow from the transaction. In a typical GRAT transaction, the business owner transfers the business interest at its fair market value in exchange for an annuity with a present value equal to the value of the business interest.

1. Creation of a GRAT

A grantor retained annuity trust ("GRAT") is an irrevocable trust in which the grantor transfers assets for the benefit of one or more beneficiaries and retains a right to receive a fixed annuity for a term of years. The GRAT must be structured to meet the requirements of IRC §2702, which requires that the value of the assets transferred to the GRAT for gift tax purposes is the fair market value of the asset transferred, less the present value of the grantor's retained annuity interest, as determined pursuant to the statutory rate of interest under IRC §7520(a)(2).

2. The Annuity Amount and Duration

The GRAT is designed to take advantage of the applicable federal rate set forth in IRC §7520, which is equal to 120% of the applicable federal rate for mid-term loans in effect at the time of the sale. The amount of the annuity is calculated as a fixed percentage of the initial fair market value of the property at the time of transfer to the trust. The GRAT must provide that the annuity amount is payable to the grantor at least annually, regardless of whether the trust has produced income equal to the annuity. If the trust's income is insufficient, the trustee must be required to invade principal to pay the annuity amount.

3. Asset Selection

In general, the assets chosen to fund the GRAT should either (i) produce sufficient income to pay the annuity amount, or (ii) be sufficiently liquid so that the trustee may sell or distribute a portion of the assets each year to satisfy the annuity amount. If the assets within the GRAT generate income or appreciate at a rate higher than the IRC §7520 rate (sometimes referred to as the "hurdle rate"), the excess income or appreciation will accumulate outside the grantor's estate for the benefit of the GRAT beneficiaries.

Practice Point. Generally, in the context of closely held businesses, a GRAT will work best if funded with a business interest that produces income. If the business interest within the GRAT does not produce sufficient income to pay the annuity amount, it will likely be necessary to obtain a valuation of the applicable business interest each year and pay the annuity amount in kind. This can be expensive and burdensome.

4. Income Tax Liability

A GRAT is necessarily structured as a "grantor trust" so that the grantor reports all income from the trust on the grantor's personal income tax return. Any transactions between the grantor and the trust are ignored and no gain or loss is recognized for the transfer of assets from the grantor to the GRAT.

5. Gift Tax Liability

a. The value of the gift, if any, to the GRAT is determined by subtracting the actuarial value of the grantor's retained annuity interest determined under IRC §7520 from the fair market value of the asset transferred. To reduce gift tax liability, the annuity

amount can be designed to minimize the value of the remainder interest, or possibly even eliminate it altogether (a so-called "zeroed-out" GRAT).

b. The IRS initially challenged "zeroed-out" GRATs, including an example in the Regulations specifically restricting this technique. See former Treas. Reg. §25.2702-3(e), Example 5. However, the Tax Court rejected the IRS's position and approved zeroed-out GRATs when such position was challenged by the Walton family. See *Audrey J. Walton* (2000), 115 TC 589, acq. 2003-44 IRB 964. Consequently, the IRS has revised the Regulations. Treas. Reg. §25.2702-3(e), Example (5) – (6).

6. Termination of GRAT; Death of Grantor

a. The assets remaining in the GRAT upon termination of the annuity term pass to the remainder beneficiaries. However, if the grantor dies before the GRAT term expires, the value of the remainder interest in the trust, including any appreciation in the value of the property, is included in the grantor's taxable estate under IRC §2036 or §2039.

b. Another effect of the *Walton* decision was the approval of GRAT terms as short as two years. A major advantage of a short-term GRAT is the reduced risk of the grantor's death during the term and subsequent inclusion of the GRAT assets in the grantor's estate.

Practice Point. Planners utilize successive short-term GRATs to create so-called "serial GRATs" or "rolling GRATs." Instead of creating one 10-year GRAT, the grantor creates a series of five consecutive 2-year GRATs, each operating independently from the other. The rolling GRAT technique minimizes the risk of market fluctuations and captures exceptional growth during any 2-year period without being diluted by weaker performance during any other 2-year term. For example, if an investment in a 10-year GRAT produces low rates of return in the initial years, requiring the trustee to invade principal to pay the annuity, the investment may never recover enough to achieve significant estate tax savings. Alternatively, poor performance during a 2-year rolling GRAT is contained within that GRAT and will not affect the subsequent 2-year GRATs. Rolling GRATs likewise minimize the estate tax consequences of the grantor's death during the trust terms. For example, the premature death of a grantor with a 10-year GRAT will cause all the appreciation of the first 9 years to be included in the grantor's estate. If the grantor dies during the last 2-year GRAT in a series of five consecutive 2-year

GRATs, all of the appreciation occurring during the first four GRAT terms is removed from the grantor's gross estate.

c. In recent years Congress has proposed, albeit unsuccessfully, to curtail the use of short-term and zeroed-out GRATs. *See* H.R. 4849 111th Cong., 2nd Sess. (2010) and S. 3533 111th Cong. 2nd Sess. (2010). In June 2011, the issue resurfaced in the Trade Adjustment Assistance Extension Act of 2011, S. 1286 112th Cong. 1st Sess. (2011), which contains the same GRAT restrictions introduced in 2010. In particular, S.B.1286 proposes to amend IRC § 2702 to require that (i) GRATs must have a minimum 10-year term, (ii) the annuity payment cannot be reduced year-to-year during the first 10 years of the term, and (iii) the remainder interest at the time of transfer to the beneficiaries must be greater than zero. However, unlike prior legislation, these GRAT restrictions would apply retroactively to January 1, 2011. If enacted, S.B.1286 would prohibit short-term GRATs and "zeroed-out" GRATs.

7. GRATs vs. GRUTs

A variation on the GRAT planning technique is the grantor retained unitrust, or GRUT. The fundamental difference between a GRAT and a GRUT is the manner in which the annuity amount is calculated. In a GRUT, the annuity is a fixed percentage, calculated annually based on fair market value of the assets during the applicable year. Since the value of the assets can fluctuate from year to year, the amount of the annuity payout will also vary from year to year. Note that additional contributions can be made to a GRUT after its creation, but no additional contributions may be made to a GRAT.

D. Additional Planning Opportunities for Successful GRATs.

In a case where a business is extremely successful, a business interest transferred to the GRAT may appreciate far more than originally contemplated. In other words, the grantor may have made the beneficiaries of the GRAT (*i.e.*, children) far wealthier than intended. In such a case, there may be an opportunity for the grantor (with the cooperation of the GRAT beneficiaries) to further tailor distribution of such assets and reduce the second generation's estate tax.

1. Reformation of an Existing GRAT

If a business owner established a successful GRAT for the benefit of his children and now desires to transfer a portion of the business interest held by the GRAT to grandchildren, it may be possible to reform the GRAT to provide new separate IDGTs for the benefit of each child's respective

children (*i.e.*, grandchildren). Each new IDGT can be seeded with cash gifts from the original grantor (*i.e*, grandparent), and thereafter, the new IDGTs can purchase a portion of the appreciated business interest (discounted, of course) from the appropriate GRAT sub-trust using the installment sale technique described in Part B above.

2. Determining Grantor of Reformed Trust

In the reformation described above, the original grantor of the GRAT should be the "grantor" of the new IDGTs due to the gift of the seed money for the IDGTs. See Treas. Reg. § 1.671-2(e)(1) ("..a grantor includes any person to the extent such person either creates a trust, or directly or indirectly makes a gratuitous transfer … of property to a trust. For purposes of this section, the term property includes cash. …)

3. Potential Income Tax Consequences

In some cases, the GRAT is designed to be a "defective" trust and maintain grantor trust status after the annuity payments are complete. In such cases, simply because the original grantor of the GRAT is the "grantor" of the new IDGT under the above scenario does not by itself also means that GRAT-grantor is the "owner" of – and therefore taxable on – the IDGTs' income. However, the original grantor of the GRAT should be deemed the "owner" of the new IDGTs if he is provided the same grantor trust power over the IDGTs that such grantor has over the GRAT. See IRC 675(4)(C). To strengthen this position, a "redundant" grantor trust power can be added—such as a special "Charitable Right" over the IDGT's assets. See IRC 674(a). See also Rev. Rul. 2004-64, 2004-27 I.R.B. 7.

E. IRC §6166: Planning for Deferral of Estate Tax

When implementing any of the planning described in Section III or IV, planners must consider the effect such transfers will have on the client's ability to elect to defer estate tax payments under IRC §6166.

1. Deferral of Estate Tax under IRC §6166

IRC §6166 permits the deferral of estate taxes for certain qualified decedents who own interests in closely held businesses. Maintaining eligibility for estate tax deferral under IRC §6166 can be crucial to ensuring that such client's estate has the time and flexibility to create liquidity to pay estate taxes and avoid a scenario in which the family must sell the business or other assets under time pressure in order to pay the estate tax.

2. Qualifying Under IRC §6166

To qualify for deferred estate tax payments under IRC §6166, the following requirements must be met: (i) the decedent must be a U.S. citizen or resident, (ii) the decedent must own a closely held business which is an active trade or business, (iii) the value of the decedent's interest in the closely held business must exceed 35% of the decedent's adjusted gross estate, and (iv) the decedent's executor or personal representative must make the election on a timely filed estate tax return.

3. Benefits Under IRC §6166

If the estate satisfies the above requirements, payment of the estate tax attributable to the closely held business interest may be deferred for up to 5 years, during which time the estate makes interest-only payments on the deferred tax. After such 5 year period, the principal and accrued interest are payable in up to 10 equal, annual installments.

V. FAMILY LIMITED PARTNERSHIP AND LIMITED LIABILITY COMPANIES

As discussed in each of the above sections, entity selection can have a significant impact on the business succession plan. When various entities and assets are involved, clients may consider setting up a family limited partnership (FLP) or family limited liability company (FLLC) as a holding company for business interests and assets which can help the client achieve the following goals:

- Centralized management and control
- Pooling of assets
- Asset protection
- Income, gift, and estate tax savings through valuation discounts

A. Family Limited Partnerships

Limited partnerships in California are governed by the Uniform Limited Partnership Act of 2008 (RULPA) (Corp C §§15900-15912.07). A limited partnership is an association of two or more persons, in which one or more of the partners are general partners and one or more of the partners are limited partners. Corp C § 15901.02(q). An individual and his or her revocable trust do not meet the requirement that a partnership must have two or more partners, although an individual and his solely owned corporation may form a partnership. See Rev. Rul. 2004-77, 2004-2 C. B. 119.

1. General Partner

A limited partnership must have one or more general partners. A general partner can be an individual or another entity, such as a corporation, a limited liability company, or a trust. General partners have control of the limited partnership and make all management decisions. They also have unlimited personal liability for the partnership's obligations. Corp C §§15904.04-15904.05. In the context of succession planning, the business owner usually wants to continue to control or manage the assets transferred to the FLP by being the general partner.

Practice Point. The identity of the general partner may have an impact on whether a discount will be applied to FLP interest in the estate of a decedent. The partnership interest of a decedent, who was the general partner and had the unilateral power to dissolve the partnership, is likely to be valued at non-discounted liquidation values. Therefore, the partnership agreements should be carefully drafted to avoid this result.

2. Limited Partner

Limited partners have no control over any partnership business decisions, although the partnership agreement may provide the limited partners with voting rights on certain internal partnership issues. Limited partners have no personal liability for any obligations of the partnership. Corp C §15903.03.

B. Family Limited Liability Companies

LLCs are a hybrid of a corporation and a limited partnership. LLCs with two or more members are treated as partnerships for federal income tax purposes unless they elect otherwise. See Treas. Reg. §§301.7701-1-301.7701-3. Single-member LLCs are ignored for federal income tax purposes unless they elect to be taxed as corporations. Treas. Reg. §301.7701-3.

1. Limited Liability

An LLC provides limited liability for all of its members, managers, and officers for any judgment, debt, obligation, or liability of the LLC (to the same extent as corporations provide for their shareholders, directors, and officers). Corp C §§17101(a)-(b), 17158(a). However, as with shareholders of a corporation, LLC members are generally subject to liability on such grounds as alter ego liability or piercing the corporate veil *(e.g.,* because of the failure to adequately capitalize). See Corp C §17101(b).

2. Managers

The members manage the LLC, unless the articles of organization provide that the LLC has a manager(s) who may, but need not, be a member(s). Corp C §§17150-17151. In the context of business succession planning, the business owner can retain control of the management of the LLC by naming himself as the manager.

3. California Annual Fee.

California charges FLLCs an annual franchise tax of $800 and an annual fee of $900 for FLLCs with total income (gross receipts) of $250,000 or more; $2500 with total income of $500,000 or more; $6000 with total income of $1 million or more; and $11,790 with total income of $5 million or more derived from or attributable to this state. Rev & T C §§17941(a), 17942, 23153(d)(1).

C. FLPs vs. FLLCs

The choice between FLPs and FLLCs depends on a variety of factors, including the following:

- The FLLC may be more attractive than the FLP in cases when only one person will own the entity for a period of time.
- If most family members will be involved in management, the FLLC may be more appropriate because limited liability is automatically extended to all members and managers of a FLLC. Corp C §§ 17101, 17158.
- The California fee on a FLLC's gross revenues may make a FLP more attractive if the entity is expected to generate significant gross revenue. Rev & T C §17942(a)
- There may be less risk in planning with FLPs because there is more case law involving partnerships than LLCs.
- Certain aspects of California law, *e.g.,* the more stringent requirements for dissolution, may make a FLP more likely to receive a valuation discount.

VI. CHOOSING AND INTEGRATING SUCCESSION PLANNING TECHNIQUES

The tools and techniques used to transfer family business interests are dependent on many variables. The principal variables that impact the selection of the technique(s) include:

- Family dynamics
- The financial resources of the business entity and the business owners
- The number of business owners and their relationship
- The nature of the assets (e.g., real estate, machinery, tangible property, inventory) held by the business
- Whether key employees are needed to maintain the business
- Income and estate tax considerations and tax rates.

Perhaps the most important variable is the business owner him or herself. As successful entrepreneurs, they often define their life by what they do. Anything which diverts them from running the business (such as succession planning) can be seen as a distraction. Planners must attempt to engage the client as early as possible to increase the chances of successful succession planning. Often, the best way to engage the client is to identify the client's business and personal objectives, and tie such objectives to the succession plan. Whether the owner's dream is to sell the business to key employees and retire in 10 years, or watch his or her grandchildren own and run the business one day, the succession plan and the various techniques integrated therein should be tied to the client's objectives.