CHAPTER 15

Business Succession Planning

Introduction

If ever there was a case that underscores the need for comprehensive business succession planning it would be the estate of Elizabeth Boyer, as reported in the *New York Times* on October 31, 1999. What started as a small summer camp in Winnipesaukee, New Hampshire, turned into a multimillion-dollar tax lien assessed by the IRS for estate taxes, interest, and penalties. Why? In part because Elizabeth Boyer failed to create a business succession plan. As a result, upon her death the summer camp and property were fully includable in her estate for estate tax purposes. Elizabeth Boyer's executors valued the business interest on Ms. Boyer's IRS Form 706 at $860,000. The IRS came up with its own valuation, a whopping $4.9 million, and then assessed a $3.9 million estate tax deficiency, including interest and penalties. Levies, tax liens, and court battles ensued, leaving the family members heartbroken and financially devastated. Had a comprehensive business succession plan been completed during Elizabeth Boyer's lifetime, this nightmare could have been avoided.

Many consider family-owned businesses to be the fabric of the U.S. economy. In fact, it is a widely reported fact that of approximately 18 million businesses in the United States, more than 80% are family owned. Family owned and operated businesses account for more than 50% of the nation's employment and over 50% of the country's gross national product.

Remarkable statistics, but even more remarkable is that over the next five years, an estimated 43% of the nation's family-owned businesses will pass from one generation to the next. Yet the majority of these family-owned businesses will not make it past the business owner's demise. Why? Because the family members will fail to put in place a workable business succession plan.

The key to the successful transfer of a family-owned business is not only to structure the transfer in the most tax-efficient manner, but also to structure the transfer in such a manner as to simultaneously promote family harmony, continuity, and leadership. The implementation of a successful plan assures the safe passing of the torch.

Unfortunately, business succession is not an easy task. In fact, only 30% of family-owned businesses survive through the second generation, and less than 15% pass successfully to the third generation. Improper planning, taxation, the failure to provide for leadership roles, and the inability to understand the process as a whole are generally the primary causes that lead to such startling statistics.

What Is Business Succession Planning?

Business succession planning is planning that fosters both the succession of leadership and the orderly transfer of control of a family business to the next generation. Business succession planning incorporates all of the tax and nontax considerations that a business owner must assess when determining whether, and, if so, how the family business is to be passed to the next generation and generations to come. In this regard, a number of factors should be analyzed when determining whether to make a transfer of all or part of the business interest to children (or grandchildren). The considerations include:

- Estate and gift tax ramifications.
- The business owner's willingness to let go.
- Family members' willingness to commit to the business.
- Maintaining equity when making distributions to participating and nonparticipating family members.
- Timing.
- Value of the business.

- Incorporating the business succession plan into the estate plan.
- Effect of the business succession plan on retirement planning.
- Maintaining an income stream, if necessary.

The orderly transfer of control in a family business should be of primary importance in evaluating when and to whom to make such gifts. Because the considerations are many and may be difficult to evaluate, a business owner should undertake a thorough and reasonable assessment of the advantages and disadvantages associated with any such transfer before gifting an interest in the family business. Finally, business succession planning is not a one-time event, but rather an ongoing process that should be analyzed on an annual basis and modified with each changing circumstance.

Who Is Responsible for Planning?

All too often, the senior members of the family are so immersed in the day-to-day operations of the business that they fail to realize the importance of implementing an effective business succession plan. It is easy for the business owner to put off business succession planning. Many owners have strong personalities and feel more comfortable remaining in control. The idea of passing the torch may be perceived as a threat to that control. Other business owners are aware that they need to plan for their succession but have a natural reluctance to begin the process.

Often, the process begins only after the owner realizes that his or her life's work is at risk and that the significant value created is in jeopardy because of a failure to plan for the future. With the highest incremental federal estate tax rates currently at 50%, it is not unusual for the ongoing value of a family business to be cut in half upon the death of the senior family member.

Conversely, once the business owner begins the process of putting a business succession plan into place, it often invigorates both the members of the family and the business. Creating a business succession plan may also give the owner the comfort and security of knowing that, as retirement approaches, the business is well positioned to pass to the next generation and the owner's income is secure for the duration of retirement.

Commitment and Execution Are Pivotal

In order to take the first step in establishing a successful business plan, a business owner must acknowledge that establishing a successful plan can effectively perpetuate the business owner's legacy while promoting family harmony. The owner must also recognize that his or her life's work is at risk without such a plan.

Dealing with leadership transition issues is just as important as dealing with tax and other financial issues that arise with any transition. To understand what is at stake, the owner should:

- Commit to creating and carrying out a business succession plan.
- Work with professional advisers to determine the market value of the business and the estate and gift taxes that would result without planning.
- Work with these advisers to structure such a plan and create a workable timetable for moving the plan forward to completion.
- Understand that the owner is pivotal for the purpose of both establishing and carrying out the plan.
- Recognize that succession planning should take on the same level of importance as the day-to-day operation of the business and that it, too, will be an ongoing responsibility that takes time and attention.
- Empower and educate successors so that they understand the responsibility associated with taking over the reins and carrying out the day-to-day responsibilities of running the business.

Seeking Professional Counsel

By committing to the creation of a business succession plan, the business owner may have undertaken the first and perhaps the most important step for the purpose of ensuring the ongoing success of the business. The second, and perhaps equally important, step is to assemble the cabinet of advisers—the business succession planning team—to help create and carry out the plan. This cabinet of advisers should include:

- An accountant.
- An estate and business succession planning attorney.
- A professional life insurance agent.
- A Certified Financial Planner (CFP).
- A banker.
- Any family members who are involved in the business.

■ *Accountant.* It is imperative that the company's accountant be involved in creating an effective succession plan. However, it is equally important for the business owner to realize that, while the accountant who has prepared the company's tax returns over the years will be an integral part of creating an effective plan, it is not unusual for another accounting firm or valuation company to be retained for the purpose of valuing the company for gifting purposes.

■ *Attorney.* Over the years, the business owner may have used an attorney to assist with general corporate matters. However, for the purpose of creating an effective business succession plan, the business owner must retain the services of an attorney whose expertise is in the area of estate and business succession planning. Attorneys who are well versed in the estate and business succession planning area are accustomed to working with companies' counsel, who generally have a good understanding of the history of the firm. In this way, the company's corporate counsel and the business succession specialist can work closely together to implement a succession plan that is best suited for the needs of the company.

■ *Insurance agent.* Early in the development of the business succession plan, one of the most common problems is outdated or inappropriate life insurance. Such life insurance policies can be owned improperly, bought for a specific purpose that is no longer required, or contain death benefits that have not kept up with the value of the business. Therefore, it is critical to bring in a life insurance agent who is familiar with estate and gift taxation and the business succession planning area as a whole. After choosing a life insurance professional, the business owner should present copies of all the life insurance contracts for the agent to review. As the business succession planning process unfolds, the agent can then report to the business owner and other advisers the agent's findings and insurance recommendations to facilitate the plan.

■ *Certified financial planner (CFP).* As part of the business succession team, a certified financial planner can work with the business owner in helping to develop the plan that works best for the owner. The CFP generally brings expertise in the areas of finance, tax, and law and can provide the team with his or her experience in working with companies in similar situations.

■ *Banker.* Many business owners have long-term relationships with banks regarding credit facilities and lines of credit, including asset-based loans, as well as day-to-day business checking and savings accounts. A banker brings financial acumen to the advisory team that is invaluable to the planners. The banker may, in fact, be able to provide the next generation with a credit facility and help finance the buyout or other transition planning devised by the family. Additionally, the banker may offer fiduciary talent as an executor or trustee to help carry out the terms of the business succession plan.

- *Family members.* Finally, and most important, the business succession planning team must include both the senior and junior family members. The ongoing success of the business as well as the business owner's security in retirement are dependent in large part upon the success of the business, which may rest in the hands of the next generation. Only after the business owner, the advisers, and the succeeding owners have all met and aired their thoughts and concerns can a meeting of the minds take place and a plan begin to develop.

At this point, two of the most important steps in the creation of a business succession plan have occurred:

1. The business owner has realized the importance of the process and is committed to implementing the plan (as well as seeing it through to fruition).
2. The business owner has put together an effective team of advisers who have the skills and dedication to assist the business owner in creating a plan that is right for the particular circumstances.

Now the team's job is to help create a plan based on the unique circumstances of the business and the goals of the owner (and the successors) and to incorporate those intentions in the most tax-efficient, harmonious, and practical plan possible.

As the new Tax Act of 2001 increased the lifetime gifting exemption to $1 million per spouse, increased the deathtime exemption equivalent, decreased the rate of tax (as more fully set forth in Chapter 5), and phased out the qualified family owned business deduction (see Chapter 20), now, more than ever, the team of advisers must thoroughly review the business owner's intent, incorporate the tax law changes into the plan, and then monitor the plan closely as time passes.

CHAPTER 16

Start with a Business Valuation

General Valuation Comments and Observations

The business owner is now committed to the creation of a business succession plan and has assembled a team of advisers. The next step is to determine the value of the family business that the owner intends to transfer. Once the value of the business has been determined, it will be relied upon to effectuate one of several business transfer techniques.

In order to help facilitate the valuation process, the owner of a closely held business should have an understanding of the valuation process. In this manner, one can take a proactive role in helping to value the company. Moreover, the appraiser and/or business valuation expert will be relying on the information provided by the business owner, as well as data from other available sources.

Estate and Gift Tax Implications

A brief overview of the tax laws is necessary to understand the importance of valuing the company for estate and gift tax purposes. For estate tax purposes, a decedent's gross estate generally includes the fair market value of all property owned by the decedent on the date of death. For gift tax purposes, the value of a gift is its fair market value on the date of the gift. Under Revenue Ruling 59-60, the term "fair market value" is defined as the amount at which property would change hands between a willing buyer and a willing seller when (1) the buyer is not under any compulsion to buy, (2) the seller is not under any compulsion to sell, and (3) both parties have a reasonable knowledge of all relevant facts.

Closely held entities are generally owned by either a small number of individuals or members of a family (or a combination thereof). As a result, there is a limited (if any) stock trading history to assist in determining the fair market value of any ownership interest in the entity. Furthermore, the fair market value of the closely held entity may vary with market conditions. Accordingly, it is important for estate and gift tax purposes that a valuation be completed each time that shares in the business are transferred to family members.

Fundamental Factors of the Business Valuation

The valuation of a closely held company requires a thorough understanding and analysis of all relevant facts surrounding the company, past, present, and future. There is no general formula that applies to any specific industry or type of business; rather, the approach to valuation must be adjusted to fit the particular type of business and the current economic conditions.

In order to maximize the tax benefits of a business succession plan, all valuations used for estate and gift tax planning must comply with the applicable tax law provisions. In this regard, the Internal Revenue Service provides in Revenue Procedure 59-60 a list of the eight fundamental factors it considers essential in providing a proper valuation of a company:

1. The nature of the business and the history of the enterprise from its inception.
2. The general economic outlook, as well as the specific condition and outlook of the industry engaged in by the subject company.
3. The book value of the company's stock and the financial condition of the business.
4. The earning capacity of the company.
5. The dividend-paying capacity of the company.
6. The company's goodwill and any other intangible assets of the business.
7. The prior sales of the company's stock and the size of the block of stock to be valued.

8. The market price for stock of corporations that are engaged in the same or similar lines of business, the stock of which is actively traded on the open market (either on an exchange or over-the-counter).

Nature of the Business and History of the Enterprise

The history of a corporate enterprise from its inception will show its past stability or instability, growth or lack of growth, diversity or lack of diversity in its operations, and other facts needed to form an opinion of the degree of risk involved in the business.

When an enterprise has changed its form of organization but carries on the same business as its predecessor, the history of the former enterprise should be considered. The history includes the following data:

- The nature of the business.
- The type of products or services.
- The business's operating and investment assets.
- The business's capital structure.
- The facilities used to carry on the business, especially significant manufacturing plants or factories and the like.
- The sales records.
- The management of the business, with due regard to recent significant changes.

The valuation is closely linked to future expectations for the business. Favorable past events that are unlikely to happen in the future are generally discounted for purposes of the valuation process. Conversely, positive events that are likely to reoccur generally provide a premium to the valuation.

Economic Outlook and Condition of the Industry

A sound appraisal of a business must consider current and projected economic conditions as of the date of the business valuation. The economic analysis must go beyond the line of business the company is in, and should include the national economy and industries related to the business of the company. Price trends in the markets for labor, commodities, and other materials used in the business can play an important role in this factor.

It is also important to examine the company in comparison with its competitors. Is the company more or less successful than its competitors in the same industry? Does the company maintain a stable position with respect to its competitors? Greater significance may be attached to the ability of the company to compete in its industry. For example, previous high profits due to the novelty of the company's products may not be sustainable as competition increases.

Many factors can affect the future expectations of the business and must be taken into consideration in valuing the company. The loss of a key manager or employee in a small business may have a devastating effect on the value of the company, particularly if the company does not have the personnel in place capable of succeeding the lost employee.

On the other hand, there may be factors that offset the loss of a manager's services. The nature of some businesses and their assets may not be impaired by the loss of a manager. Furthermore, the economic loss caused by the death of a key manager may be covered by life insurance, or new management may be readily available outside the company.

Book Value of the Stock and Financial Condition of the Business

If the company has maintained formal accounting records, the owners should provide the balance sheets of the company to the valuation experts. Most valuation experts compare annual financial statements for at least the five-year period immediately preceding the desired appraisal date, as well as the monthly balance sheets for the most recent months preceding the valuation.

The financial statements of a company will usually disclose the following data:

- Liquid position of the company (ratio of assets to current liabilities).
- Gross and net book value of the company's principal classes of fixed assets.
- Working capital.
- Long-term indebtedness.
- Capital structure.
- Net worth or book value.

Any balance sheet descriptions that are not self-explanatory, as well as items composed of multiple assets or liabilities, should be explained in detail by supplemental information provided by the company.

Consideration should be given to nonessential assets, such as investments in securities, real estate (if unrelated to the business), and so on. In general, assets not required in the operation of the business will be considered separate from operating assets.

In computing the book value per share of stock, investment assets should be revalued on the basis of their market value. Comparison of the company's balance sheets over several years may reveal developments such as the acquisition of additional production facilities or subsidiary companies, improvement in financial position, and changes in the capital structure of the business.

If the corporation has more than one class of outstanding stock, the explicit rights and privileges of the various classes of stock must be examined, including:

- Voting powers.
- Preference as to dividends.
- Preference as to assets in the event of liquidation.

Earning Capacity of the Company

Detailed profit-and-loss statements should be obtained and considered for the period immediately prior to the business valuation, preferably for five or more years. Statements should show the following information:

- Gross income by item.
- Principal deductions from gross income including: major expenses; interest paid on each item of long-term debt; depreciation and depletion deductions taken by the company; officers' salaries (in total if they appear to be reasonable or in detail if they seem to be either excessive or understated); charitable contributions (whether or not deductible for tax purposes); and taxes paid (including income and excess profits taxes).
- Free cash flow available for dividend payments.
- Rates and amounts paid on each class of stock.
- Surplus amounts.
- Adjustments to and reconciliation with surplus as stated on the balance sheet.
- The percentage of earnings retained by the company for business expansion.

With the availability of detailed profit-and-loss statements, the valuation expert should be able to separate recurrent from nonrecurring items, to distinguish between operating income and investment income, and to ascertain whether any line of business in which the company is engaged has operated consistently at a loss and might be abandoned with benefit to the company.

Potential future income is a major factor in valuing a closely held business. All information concerning past income and its effect on predicting the future should be obtained. Prior earnings records usually are the most reliable guide as to future expectancy. The use of arbitrary 5- or 10-year averages, without regard to current trends or future prospects, may not produce a realistic valuation. If, for instance, a record of progressively increasing or decreasing net income is found, greater weight may be accorded the most recent years' profits in estimating earning power, rather than profits from earlier years.

Dividend-Paying Capacity

In general, a business valuation will also focus on the dividend-paying capacity of the company. However, in closely held family companies, the historic dividends paid by the company are generally not a good measure of the company's value. This is because the past payments of dividends in a small business (if any) are often related to the needs of the stockholders and may be dictated by income tax planning considerations.

Furthermore, if a controlling ownership interest in a company is to be valued, the dividend factor is even less significant since the payment of dividends is at the discretion of the very interest being valued. The controlling party can substitute salaries and bonuses for dividends to reduce net income, thus understating the dividend-paying capacity of the company. It follows, therefore, that dividends are a less reliable criterion of fair market value of a closely held family business than other applicable factors.

Goodwill and Other Intangible Assets

In the final analysis, goodwill and other intangible assets are tied to the company's earning capacity. Goodwill may be viewed as the capitalized value of the excess amount of the company's net earnings over a fair return on the company's tangible assets. Other factors such as the prestige and reputation of the business, the ownership of a trade or brand name, and a record of successful operation over a prolonged period in a particular locality should be considered in determining the value of a company.

Sales of the Stock

Prior sales of stock in a closely held corporation should be carefully investigated to determine whether they represent fairly negotiated transactions. Forced or distress sales do not ordinarily reflect fair market value, just as isolated sales or sales of stock in small amounts do not necessarily reflect an accurate measure of value. This is especially true if the valuation involves either a large controlling interest (on the one hand) or a small minority interest (on the other hand).

Sales of stock in comparable corporations should also be factored into the valuation. In selecting corporations for comparison purposes, care should be taken to use only corporations engaged in the same or similar lines of business as the appraised company to avoid comparisons with companies that are in higher- (or lower-) growth industries.

All relevant factors must be considered when analyzing sales of comparable companies. For instance, a corporation having one or more classes of preferred stock in addition to its common stock should not be considered directly comparable to an entity with only common stock. Likewise, a company with a declining business and decreasing markets is not comparable to a business with a record of earnings growth and market expansion.

The size or "block" of the ownership interest itself is also a relevant factor to be considered in the valuation process. A minority ownership interest in an unlisted corporation's stock is more difficult to sell than a similar block of listed stock. It is equally true that a controlling interest in a corporation may justify a higher value for a specific block of stock.

All of the foregoing factors and any other offsetting considerations should be carefully considered and weighed by the appraiser. Once the value of the overall business is determined, the final step in the valuation process is to determine whether any of the discounting techniques discussed next apply to the subject company.

Valuation Discounts

A business owner should recognize that if one owns publicly traded stock, there is a ready market for such securities and the current price of such securities can be easily determined. However, with respect to the sale of a closely held business interest, there may not be a ready market for the sale of an interest in the business. Accordingly, the valuation expert can discount the value of the company based on any number of factors unique to the owner's closely held business, including, specifically, the absence of a ready market for the shares of stock in the company.

For estate and gift tax purposes, discounts serve to decrease the value of any ownership interest transferred by gift to family members. This effectively achieves a leveraged effect by maximizing the use of the owner's $11,000 annual gift tax exclusion and/or exemption equivalent for purposes of passing interests in the family business to the owner's heirs.

When assessing the valuation discount associated with the transfer by gift of stock in a family-owned business, it is imperative for the business valuation expert to assert a reasonable position in determining how great a discount is warranted in light of the specific circumstances surrounding the family-owned business. Taking too great a discount may have the potential for inviting an IRS audit that may lead to protracted litigation and potential reduction in the discounts originally taken. Such a result is costly and can severely hinder future gifts by the senior members of the family-owned business.

Although courts generally consider the valuation opinions of expert appraisers, they have also demonstrated a willingness to disregard the experts and render their own opinions as to valuations. In *Mandelbaum v. Commissioner, T.C. Memo 1995–255*, the United States Tax Court sought to value the shares of a family-owned corporation in New Jersey. In that case, the taxpayer's experts had assessed a 70% discount on the shares of stock transferred to the owner's heirs because of an absence of a market for the shares. The IRS challenged the 70% discount and the battle ensued.

The Tax Court considered numerous factors regarding the corporation, including specifically the ability to trade the shares of stock in a free and open market. In its opinion, the Court found that the corporation's ability to make substantial dividends, with a strong and proven management team, and the fact that the corporation was considered a leader in its industry did not coincide with the taxpayer's position that the stock warranted such a substantial discount. Rather, based on the factors set forth in the case, the Court determined that a 30% discount for lack of marketability was appropriate. This discount appears reasonable in light of the surrounding facts. It was the taxpayer's experts' valuation report that was ultimately considered unreasonable.

Different Types of Valuation Discounts

There are several types of discounts, including, but not limited to, the following:

- Lack of marketability discounts.
- Minority interest discounts.
- Information access and reliability discounts.
- Key manager or thin management discounts.
- Comparability discounts.
- Investment company discounts.
- Market absorption or blockage discounts.
- Built-in capital gains discounts.

The lack-of-marketability and the minority discounts are the two discounts most generally applied in valuing the stock of closely held companies. However, several other adjustments or discounts should also be routinely considered when determining the value of shares in a closely held business for gifting purposes.

Marketability Adjustments

One of the most frequently used discounting techniques is the adjustment for lack of marketability. This lack-of-marketability discount is based on the fact that stock in a closely held business is not readily transferable, and thus it is not as attractive to potential investors.

As a result, stock in a closely held corporation is more difficult to sell than publicly traded stock and is thus worth less than readily tradable stock. Accordingly, the valuation expert may discount the value of the stock in a company by the fact that a ready market does not exist for the stock in the company.

The determination of the lack-of-marketability discount should incorporate the findings of various published studies that provide a basis for selecting such a discount. These studies typically revolve around four methods of quantifying the discount associated with the lack of marketability for the stock:

1. Comparison of private placements of restricted stock of otherwise publicly traded securities of the same company. (Since the difference between restricted stock and publicly traded stock in the same company is based solely on the ability to trade the security on a public exchange, the discount for lack of marketability is established by the price difference between the restricted and unrestricted stock.)
2. Comparison of sales of closely held stock subsequently brought public.
3. The cost (or "float") of publicly offering the stock.
4. Close analysis of court cases.

Based on these studies, it has been determined by experts and confirmed by the courts that a lack-of-marketability discount is generally warranted for stock in a closely held company. Based on these facts, it is not unusual for a lack-of-marketability discount to reduce the value of the shares of stock in a closely held business being transferred by as much as 20% to 50%.

Minority Interest Discounts

Another important consideration when determining the value of stock in a closely held company is the minority interest discount. When executing a business succession plan, it is typical for the owner to transfer a minority (noncontrolling) interest in the company to heirs and for the process to be continued over a period of time. The Internal Revenue Service recognizes that stock that does not reflect a controlling interest in a company is not worth as much as the stock held by the stockholder who retains control. Accordingly, this lack of control has a direct bearing on the value of the stock being transferred.

If the recipients of such stock have no rights over the control of the operation of the company, including specifically any rights to make distributions to themselves as shareholders, this aspect has a direct bearing on the value of the stock being transferred. The minority discount is recognized because the beneficiaries lack control over corporate policy, cannot direct the payment of dividends, and cannot compel liquidation of the company. Because of this lack of control, a willing purchaser of such an interest would pay far less for it on a pro rata basis than for a controlling interest.

The idea of the minority discount can best be illustrated by a hypothetical example of the Acme Corporation, owned by four shareholders: John, 25%; Freda, 25%; Michael, 25%; and Gloria, 25%. The corporation has been valued at $10 million, and Michael is seeking to transfer his 25% to members of his family.

If the accountant who prepared the valuation of Michael's shares simply took the $10 million valuation and multiplied it by Michael's 25%, then clearly his interest would be valued at $2.5 million. However, if the accountant recognized that Michael is merely a minority shareholder (without the ability through his 25% vote to declare distributions of profits, approve sales or control the vote on any corporate issue), Michael's shares would clearly be eligible for the minority discount. Consequently, the valuation expert may affix a discount to Michael's 25% interest in Acme. In this manner, if the expert were to affix a 40% discount to Michael's shares, the value of the gift could be decreased by 40% and the $2.5 million value would be reduced to $1.5 million.

Observe that the marketability discount and minority discount are different concepts. The lack-of-marketability discount will nearly always apply in the case of a closely held company even when the shares involved represent a controlling interest, whereas the minority adjustment will apply only when a noncontrolling interest is being transferred to each beneficiary.

Information Access and Reliability Adjustments

A valuation is based on the information available to the valuation expert as of the date of the business valuation. The hypothetical willing buyer and willing seller have reasonable knowledge of the relevant facts, but do they have assurances that the financial details relating to the enterprise will be made available in the future?

Much of the information used by a valuation expert is provided by the business owners themselves. Closely held businesses do not always maintain formal records such as financial statements prepared in accordance with generally accepted accounting principles. The information provided to the valuation expert on a particular company can range from the extensively detailed statements maintained by companies subject to the securities laws and stock exchange requirements to unaudited financial reports kept by company bookkeepers. Interestingly enough, this very uncertainty regarding the reliability of the data provided can be a basis for an additional valuation adjustment. The valuation expert has to take the quality of the information provided into account when valuing the business of a closely held company.

Key Manager or Thin Management Adjustments

There is greater risk (and thus a lower value) for a company whose future is dependent on one or only a few key managers when compared to a company with a management team tied to the company. This key manager discount often applies to closely held or family businesses because the ongoing success of the company is many times dependent on only one or two key individuals.

Comparability (Small Company) Adjustments

Comparability or small company discounts may be warranted when large, publicly traded companies are used as the standard for valuation. The same factors warranting marketability and thin management adjustments may be present here, but the main element is that the higher return demanded by investors from smaller companies is reflective of the financial risk of investing in smaller companies, which have less financial clout in terms of access to capital through public offerings or lenders. A smaller company may not have the same ability to survive a business or financial reversal or economic downturn, adding to the risk involved. Thus, when valuing a small closely held company, the valuation expert will assign a discount to the stock to reflect these risks.

Investment Company Adjustments

Investment company adjustments are usually applied in situations when the valuation of a private investment company (such as a financial, real estate, or natural resource company) is based on the market values of the underlying assets owned by the company rather than its earnings. From a pragmatic viewpoint, in order to obtain the value of the company's assets, the company may have to expend time and money to sell its assets. Buyers of such assets may not be easily found, and taxes will be due on such sales. Accordingly, a discount may be assigned to the stock of such a company to reflect the costs and uncertainties surrounding the potential realization of the value in the company.

This discount reflects the delay and expenses of realizing any profit from the company's assets. It also reflects the observation that although there is data establishing the underlying value of the assets owned by such a company, there is an entirely separate market for the buying and selling of ownership interests in investment companies themselves. In contrast to the minority discount, even a near 100 percent owner may be entitled to this discount.

Market Absorption [Blockage] Adjustments

A market absorption or blockage discount is generally applicable when the size of a block of stock to be sold is so large in comparison to the daily volume in an otherwise active market that it cannot be absorbed in the normal course of trading. The size of a blockage discount will reflect the value of the block of stock as determined by the price an underwriter would get on behalf of the seller through the sale of the block of stock outside normal market channels.

When an owner seeks to sell an unusually large block of stock in a company, the size of the block will depress the market for the stock and consequently reduce the price the seller would otherwise receive in an open market. This blockage discount differs from the lack-of-marketability discount discussed earlier, which is premised on the absence of a ready market for the stock. In the case of a blockage discount, there is a market but it cannot absorb the block of stock being offered for sale. Obviously, this type of analysis rarely comes up when valuing the stock of a closely held business.

Built-In Capital Gains Discounts

The capital gains discount is premised on the fact that many family-owned businesses were created and initially capitalized decades ago with low or minimal funding. Fortunately, over the years, the company has significantly appreciated in value. However, as a result, if there was a sale of the stock in the company, significant capital gains tax would be due. The fact that such a tax liability exists will have a direct impact on what the value of the business would be in the event of a sale and thus on the value of the stock in the company.

As this discount has only recently been recognized in a decision rendered by the Second Circuit Court of Appeals, there is little precedent as to what the applicable discount for the built-in capital gains liability might be. However, the accountant or the valuation expert should be able to establish the potential tax liability and apply a reasonable discount accordingly.

Multiple Discounts

These discounts do not exist in a vacuum, but rather more often overlap each other. Accordingly, the valuation expert will be able to combine the various discounts to reflect the value of the stock to be gifted, further reducing the value of the gifts. However, multiple restrictions may increase discounts only marginally. For example, a minority discount will have less of an impact on the value of the stock being transferred if a lack-of-marketability discount has already been taken into consideration. In this fashion, each discounting factor will have only an incremental effect on the value of the stock being transferred. Thus, in valuing the stock, the valuation expert will look to the discounts in concert and arrive at a valuation only after analyzing all of these discounts together.

Conclusion

The business owner, committed to the process of a business succession plan, has now completed the valuation and must make a determination as to how many shares should be transferred to his or her successors. The business owner must now work with advisers to make this determination. In this regard, legal and accounting advisers should provide the owner with information as to the gift tax implications of any plan and the appropriate estate and business succession planning tools to implement the plan. The business succession planning attorney must review any existing buy-sell agreements that govern restrictions on transfers of shares and ensure that any such agreements represent the current status of the corporation and allow for the transference of business interests. The review, creation, and modification of the buy-sell agreement is crucial to the business succession planning process and is discussed at length in the next chapter.

CHAPTER 17

Buy-Sell Agreements

Introduction

As if creating a successful business isn't hard enough, now add the dilemma of what happens if one of your partners or shareholders dies, becomes disabled, or wants to retire. Generally, what most business owners do not see as a viable solution is having the spouse of the deceased, disabled, or retired shareholder become a new partner in the business. Nor does the spouse of such deceased, disabled, or retired shareholder generally want to jump into such a role.

Typically, in the event a shareholder dies, the spouse of the deceased shareholder is generally looking for only one thing—to be bought out of the deceased spouse's interest in the company, generally for cash. In the event that a shareholder becomes disabled, hopefully the business will continue to exist, but the remaining partners who are operating the business on a day-to-day basis will generally feel a little put-upon by the disabled partner who is no longer contributing to the business and yet continues to receive a full share of the profits. Also, the disabled partner may generally feel a sense of guilt by continuing to maintain ownership in the business and pulling out profits for which he or she is not contributing any value.

A partner-shareholder who is ready to retire and reap the rewards of many years in the business may be looking to the other partners to buy his or her share in the business. However, if the business does not have the liquidity to buy out the retired partner, once again inequities may arise if the retired partner is no longer contributing to the business yet continues to demand a share of the profits.

A buy-sell agreement is intended to address the issues of what happens upon the death, disability, or retirement of a partner or shareholder in a closely held business. Thus, in order to effectively draft a buy-sell agreement to address these issues, a comprehensive review must be undertaken to accurately determine the company's purpose, the partner's or shareholder's needs, the value of the business, and the events that will trigger a buyout. As touched upon earlier, a well-drafted buy-sell agreement is designed to address many of the problems associated with creating a business succession plan for a family-owned business.

The four primary issues that should be dealt with in an effectively drafted buy-sell agreement are:

1. Setting the terms for any future purchases or sales of stock by and between the current owners and their successors or other family members.
2. Establishing the purchase price or a formula for calculating the purchase price for any such future transfers of stock between the shareholders upon death, disability, or retirement.
3. Imposing restrictions on any transfers of stock, whether to outside third parties or to other family members.
4. Specifying whatever arrangements are necessary if a shareholder were to die, become disabled, or retire, including specifically the terms upon which any buyout will take place. In this regard, one of the primary issues to be addressed is whether, upon the death of a shareholder, the deceased owner's stock should be purchased by the surviving owners (referred to as a "cross-purchase agreement") or by the business itself (referred to as a "redemption agreement").

Use of a Buy-Sell Agreement upon the Death of a Shareholder

Although a properly drafted buy-sell agreement will address the buyout of a stockholder upon either death, disability, or retirement, the primary focus of this chapter will be the use of such an agreement upon the death of a stockholder. However, many of the concepts discussed in this chapter apply equally to the issues arising upon the disability or retirement of the shareholder.

Most buy-sell agreements are designed to serve certain common purposes in dealing with the death of a shareholder in a closely held business. A primary purpose of the buy-sell agreement is to maintain the continuity of management of the business and to prevent the deceased owner's family from creating conflicts that might injure the business or infringe upon its ongoing success following the death of a shareholder. A properly drafted buy-sell agreement allows the surviving owners to continue to manage the business without interference from the family and other heirs of the deceased owner.

A second purpose of the buy-sell agreement is to provide cash to the deceased owner's estate and/or family. Unlike publicly traded securities, stock in a closely held business generally has no ready market. The buy-sell agreement will provide for the purchase of a deceased owner's shares, either by the surviving shareholders through a cross-purchase agreement or by the company itself through a redemption agreement. By providing for this acquisition of stock from the decedent's estate, the buy-sell agreement in essence converts the deceased owner's unmarketable securities into readily available cash and/or a long-term income stream. This use of a buy-sell agreement thus provides the decedent's estate and family with much-needed funds to pay for ongoing living expenses and taxes as well as funeral and estate expenses.

Use of a Buy-Sell Agreement in Determining Price for the Stock of a Deceased Shareholder

The buy-sell agreement should help establish the value of the deceased owner's interest in the closely held business for buyout, as well as estate tax purposes. Through the use of a buy-sell agreement, the owners of a closely held business are able to utilize any one (or a combination) of several alternative methods for the purpose of establishing the price for which the survivors, either directly or through the company, will acquire the deceased owner's interest. This chapter will examine some of the more common pricing methods.

Agreed Value Method

The owners of a closely held business are usually in the best position to know the true value of their business. Under the agreed value method, the owners agree in advance to a specific purchase price. If an owner dies, that interest will be purchased from the estate for a specified dollar amount, no matter when the death occurs. Since the purchase price is fixed, there will be less uncertainty resulting from the death of an owner, and the parties will have ample opportunity to provide for funding sources to complete the acquisition.

This agreed value method can be perceived as a very simple method to implement once the shareholders have mutually determined a price at which they agree to receive (or pay) for a decedent's stock. However, if the business experiences any substantial changes over time (as every business does), this method may eventually result in a price that is either too high or too low.

One solution is for the buy-sell agreement to require the owners to periodically review and update the agreed value based upon changes in the business. Since typical owners often forget to update the agreed value set forth in their buy-sell agreement, the buy-sell agreement can also include a provision allowing the owners to reject the agreed value if it has not been updated for several years.

The primary benefit of using an agreed value method of valuation is that it provides a simple and inexpensive way to eliminate uncertainty in the value of a closely held business. The primary disadvantage of using this method is that it may result in an inaccurate price for the owners of a business with a fluctuating value. Furthermore, the value agreed upon by the owners of the business need not be respected by the IRS, resulting in a buyout price substantially below the amount the IRS may think the company is worth at the death of a shareholder. This can result in higher estate taxes for the estate of the deceased shareholder, yet insufficient funds to pay those taxes.

Formula Value Method

The formula value method is frequently found in more sophisticated buy-sell agreements because the formula value method, by its very essence, is designed to address the very changes that take place as a business builds and grows with each passing year. In arriving at a formula value, the owners should take into consideration the unique qualities of their business. Formula values can be based on book value (with certain adjustments), a multiple of earnings (net or gross), or a combination of any number of reasonable factors.

Book value is frequently a poor measure of a business's value since it generally represents historical valuations (adjusted for depreciation), which usually bear little or no resemblance to the current fair market value of a company's ongoing business. Book value fails to take into consideration a business's earning capacity or the value of its goodwill as an ongoing concern.

Capitalization of earnings, which multiplies the earnings of a business by a predetermined factor, takes into consideration the business's earning capacity and goodwill, but it may not take into consideration the true value of the assets owned by the business. Thus, it is imperative that the business owners work together with their advisers to develop a formula that reflects the true nature of their business. However, as in the case of the agreed value method, the owners should revisit their predetermined formula on a periodic basis to ensure that it still reflects their business model.

Appraisal or Arbitration Value

Under the appraisal or arbitration value method, the owners agree in advance that, upon the death of an owner, the value of the company will be determined either by an appraisal of the business or by arbitration.

Utilizing the appraisal or arbitration method to determine the value of a business is costly and time-consuming, but may result in a value that is closer to the fair market value of the decedent's shares at the time of death than certain other methods discussed here. For instance, under the appraisal method, both the estate and the surviving member(s) of the business are generally advised to seek separate appraisers. If the two appraisers cannot agree on a value, the parties are generally required to agree on a third appraiser whose decision will be final (unless the two sides sue each other). The parties have now paid for three appraisals of the business, each of which can be very expensive.

Furthermore, the value determined by the appraisers (or by an arbitrator) may be totally contrary to what the shareholders would have actually agreed upon had they all been alive at the time. Thus, because of all of the uncertainties, costs, and burdens placed on the business and the surviving members of the business (as well as the family of the deceased member), this valuation method is generally not recommended when drafting a buy-sell agreement.

Acceptance of Price Determination Methods by the IRS

For estate and gift tax purposes, an agreed value, formula value, or appraisal/arbitration value that is established pursuant to the terms of a preexisting buy-sell agreement will generally be respected by the IRS as the value of the business interest of the deceased shareholder, provided that:

- The buy-sell agreement was negotiated and entered into by the parties at arm's length.
- The decedent's estate is bound by the agreement to sell the decedent's interest to the remaining shareholders of the company (or the company itself).

- The purchaser (whether the surviving owners or the business) is obligated to purchase the decedent's interest or has an option to do so.
- The business interest could not have been disposed of during the lifetime of the decedent without first offering it to the company or to the other shareholders at a price no higher than the one fixed at the time of the decedent's death.
- The method used closely parallels the value of the company, as best calculated by all of the parties while alive, and the price specified in the agreement is fair and adequate as of the time the agreement is entered into by the parties.

On the other hand, if the buy-sell agreement is between related parties and the IRS determines that it consists of nothing more than a device designed to pass on a decedent's interests to "the natural object of his or her bounty for less than full value," the agreed price may not be binding for tax purposes.

Cross-Purchase versus Redemption Agreements

If, under the terms of a buy-sell agreement, when a business owner dies, his or her shares are required to be bought by the surviving owners of the business, the agreement is generally referred to as a cross-purchase agreement. If, however, under the terms of the agreement, the decedent's shares are required to be purchased or redeemed by the business itself, the agreement is generally referred to as a redemption agreement. A determination as to whether to utilize a cross-purchase agreement as opposed to a stock redemption agreement depends on the unique facts and circumstances of the business, including the type of entity involved—that is, a corporation, partnership, or limited liability company.

Corporate Buy-Sell Agreements

In determining whether a cross-purchase or redemption agreement should be utilized in a corporate setting, many factors should be considered, including the following.

Tax Consequences

In certain circumstances, a cross-purchase agreement may be preferable to a stock redemption agreement. For instance, with a cross-purchase agreement, the surviving shareholders get a cost basis in the stock equal to their purchase price, whereas with a redemption agreement they do not get a step-up in the basis of their shares because the company is deemed to have acquired the stock of the deceased shareholder.

For example, A and B each own 50% of the stock of a corporation. The tax basis of each 50% interest is $100,000, and the fair market value of each 50% interest is $500,000. Under a stock redemption agreement, if A dies, B's basis in his stock of the corporation (which now constitutes a 100% ownership interest), remains at $100,000 because B simply owns the same shares he owned prior to the redemption.

However, under the terms of a cross-purchase agreement, B is required to purchase A's stock directly from A's estate for $500,000. As a result, B's basis in the stock he acquires from A's estate ($500,000) is added to the $100,000 basis in the shares he already owns for a total basis of $600,000 in all of the stock he now owns after A's death. If it appears likely that the surviving shareholder will sell the business after the death of the other shareholder, serious consideration should be given to structuring the buy-sell agreement in the form of a cross-purchase agreement rather than as a redemption agreement.

In most instances, the form of agreement makes no difference to the deceased shareholder's estate for federal income tax purposes. In either case, the sale will result in no gain or loss because the estate will have received a new or stepped-up basis for the stock of the deceased shareholder equal to the purchase price (whether bought by the company or by the surviving shareholders). However, this favorable tax treatment applies to a redemption agreement only if the redemption is treated as a capital transaction rather than as a dividend taxable as ordinary income. In this regard, the general rule is that any distribution of money or property by a corporation to a shareholder (including a deceased shareholder's estate) will be taxed as a dividend to the extent of the corporation's earnings or profits, unless one of the following four exceptions apply:

1. The redemption payment completely terminates the stockholder's ownership interest in the corporation.
2. The redemption of stock is not being made on a proportionate basis for all stockholders and therefore is substantially disproportionate to the interest of the shareholders.
3. A distribution results in a partial liquidation of the corporation.
4. The distribution is not essentially equivalent to a dividend.

The most common method used to avoid the treatment of a distribution as a dividend at the time of the death of a shareholder is to have the redemption qualify as either a complete or "substantially disproportionate" redemption. In satisfying the tests for disproportionate or complete redemption, the rules of "constructive ownership" set forth in the Internal Revenue Code are applied in determining the number of shares a shareholder owned both before and after the redemption. For this purpose, living shareholders are deemed to own the stock of their spouses, children, grandchildren, and parents, in addition to their own stock.

In addition, stock owned by a beneficiary of a deceased shareholder's estate is considered to be constructively owned by the estate and such stock is considered as owned proportionally by its beneficiaries regardless of whether they are related to the deceased shareholder for purposes of applying the tests. As a consequence, if one of the beneficiaries of the deceased shareholder's estate already owned stock in the corporation, the estate may be considered, for tax purposes, as owning such stock, resulting in ordinary income treatment to the extent of earnings and profits of the corporation, rather than as a tax-free capital transaction. Thus, care must be taken to ensure that a buy-sell agreement structured as a redemption agreement does not inadvertently cost the estate of a deceased shareholder increased taxes that could otherwise have been avoided by structuring the buy-sell agreement as a cross-purchase agreement. The shareholders of a closely held family business should work with the firm's accountants and attorneys to avoid this tax trap.

Unequal Ownership

In those situations in which the shareholders of a company do not own equal shares in the company, it may be inequitable for the buy-sell agreement to be structured as a redemption agreement, since in such instances the majority shareholder may end up paying a disproportionate share of the costs associated with a buyout.

For example, assume a closely held business has two shareholders, A and B. A owns 70% and B owns 30% of the stock in the corporation. Under a stock redemption agreement funded with insurance, the premiums are generally paid for out of the earnings of the company. In such instances, but for the buy-sell agreement, A would have received 70% of the amount that went to pay for the insurance premiums and B would have received 30%. Thus, A ends up paying a disproportionate amount of the premiums for the insurance used to buy up B's 30% of the company. Under a cross-purchase agreement, each shareholder will typically use his or her own funds to purchase the other's stock, so that these disproportionate payouts can be avoided.

Number of Shareholders

If there are a significant number of shareholders in the corporation, and the buy-sell agreement is to be funded with life insurance, a redemption agreement may be preferable to a cross-purchase agreement. In such instances, the use of a redemption agreement will reduce the administrative burden associated with structuring the acquisition of life insurance. A cross-purchase agreement requires each stockholder to purchase life insurance on the other stockholders.

For example, if a corporation with 10 shareholders adopts a redemption agreement, only 10 life insurance policies will need to be acquired by the corporation. However, if the shareholders have entered into a cross-purchase agreement, each of the shareholders would have to acquire nine policies, one on each of his fellow shareholders' lives, making a total of 90 life insurance policies necessary to fully fund the agreement. A stock redemption agreement doesn't involve the administrative problems of dealing with so many policies. In the alternative, shareholders who insist on using a cross-purchase agreement should consider establishing a partnership for the purpose of holding the policies on each other's lives.

State Law Restrictions on Redemption

If a stock redemption agreement is adopted by the company, it may be necessary to satisfy certain requirements of state law before making the necessary redemption at the time of a shareholder's death. For example, in some states, stock may be redeemed only out of earned or other specifically designated types of surplus. If the purchase is not funded with life insurance (thus providing the needed surplus or retained earnings under state law requirements), it may be necessary, when state law causes a redemption problem, to provide that if the corporation cannot legally redeem all of the decedent's stock, the surviving shareholders will either be compelled or have the option to purchase such stock.

Partnership or Limited Liability Company Buy-Sell Agreements

With regard to a buy-sell agreement for either a partnership or a limited liability company, there exists a major tax distinction between a cross-purchase agreement and a redemption agreement in the treatment of goodwill. With a cross-purchase agreement, the portion of the interest in the business attributable to goodwill is treated as a capital asset for tax purposes. Thus, the payment of the portion of the purchase price attributable to such goodwill is not deductible by the partnership or limited liability company. Since the partnership or limited liability company interest acquired by the surviving owners of the company will receive a new tax basis on the deceased owner's death equal to the purchase price, the portion of the purchase price attributable to goodwill, which is treated as part of the capital transaction, will not be included in the taxable income of the deceased owner's estate.

On the other hand, if a redemption agreement is used, the partners or members have a choice. If the agreement states that a specific amount is to be paid for goodwill, the payment for this amount is treated as the payment for a capital asset. If the agreement is silent as to the amount of the redemption price allocable to goodwill, the portion of the purchase price allocable to goodwill may be considered as an income item and may be taxable as ordinary income to the deceased owner's estate and be deductible by the surviving partners of the partnership or surviving members of the limited liability company, as the case may be. In return for receiving this income tax deduction, the parties may be willing to have the buy-sell agreement provide for a larger goodwill payment than they would otherwise.

Another important tax issue regarding the issue of a buy-sell agreement in the context of a partnership or limited liability company involves the tax consequences of interest earned by the deceased partner on any obligations in the year of death. Unless there is a buy-sell agreement to the contrary, the death of a partner may not close the partnership or limited liability company's tax year. Accordingly, when a partner or member dies, that person's share of income or loss for the tax year ending after the death will be included in the estate income tax return rather than in the deceased owner's final income tax return. Depending on whether a lower or higher income tax results from reporting the deceased owner's share on the estate income tax return rather than on the decedent's final return, there may be a substantial benefit or detriment, depending on the particular facts and circumstances. However, when there is a buy-sell agreement terminating the decedent's interests at the time of death, the partnership or limited liability company's tax year (with respect to the deceased owner) will close as of the date of sale. If the sale under the buy-sell agreement occurs as of the date of death, then the tax year is deemed to close on the date of death and the deceased owner's share of income or loss will be included in the decedent's final return.

Conclusion

As you can see from the issues identified in this chapter, numerous questions surrounding the death, disability, or retirement of a business owner can and should be addressed in a properly drafted buy-sell agreement. In this regard, it is imperative that the owners of a business sit down with their advisers and go through all the various issues unique to their business before entering into such an agreement. However, once a properly thought-out agreement has been reduced to paper, it can save numerous headaches if and when one member of the business should pass away, become disabled, or decide it is time to head for the retirement community.

CHAPTER 18

Funding Buy-Sell Agreements

Introduction

Having established the value of the business and drafted a buy-sell agreement, the shareholders of a company need to consider how to fund the sale of shares in the event of death, disability, or retirement of any or all of the shareholders. Depending on their financial means, the shareholders may agree that upon a triggering event such as the death of a shareholder, the surviving shareholders (under a cross-purchase agreement) or the corporation itself (under a redemption agreement) will simply buy out the decedent's shares from the deceased shareholder's estate using either corporate assets or their own personal resources.

However, the value of the deceased shareholder's interest as determined by the terms of the buy-sell agreement may be substantial, and corporate assets or an individual's own resources may not be either available or adequate. The surviving shareholders (or the corporation itself) could borrow the funds necessary to satisfy the terms of such an all-cash buyout. However, it would be far more advantageous to the surviving shareholders if the buy-sell agreement also provided for payments to be stretched out over a period of time. In such an event, the surviving shareholders could, for example, put down a lump sum (10% or 20%) and pay the remaining obligation under the terms of an installment agreement set forth in the buy-sell agreement, which could run for a number of years at an agreed-upon interest rate.

Shareholders should consider several factors before agreeing to an all-cash purchase or installment note obligation. First, the heirs of the deceased shareholder may need to live, at least in part, on the value of the decedent's shares. In this regard, the surviving spouse may not be able to support a family on the payments provided under a long-term installment obligation. On the other hand, the surviving shareholders may not be able to make the note payments under the installment agreement throughout the term of obligation, particularly if the deceased shareholder was key to the ongoing success of the business, potentially reducing the earnings of the company following the key manager's death.

Can Life Insurance Help?

In order to avoid the financial uncertainty of a long-term installment note buyout, the business owners' advisers may recommend that the buy-sell agreement be funded with life insurance purchased on the lives of the respective shareholders. With a cross-purchase buy-sell agreement, each shareholder purchases a life insurance contract on the lives of the other shareholders. For example, assume the Warren Corporation has four shareholders, John, Fred, Chris, and Phil:

- John, Fred, and Chris would purchase life insurance on Phil.
- Fred, Chris, and Phil would purchase life insurance on John.
- Chris, Phil, and John would purchase life insurance on Fred.
- Phil, John, and Fred would purchase life insurance on Chris.

Structuring a buy-sell agreement under the cross-purchase method provides the funds necessary to immediately buy out the shares held by the deceased shareholder's estate without having to assume the obligations of an installment agreement. Under such an agreement, the surviving shareholders are obligated to buy, and the estate of the deceased shareholder is obligated to sell, the shares held by the deceased shareholder at the time of death. The life insurance policies are purchased to ensure that the surviving shareholders have sufficient cash to make the necessary payment in one lump sum. In order to simplify the acquisition of life insurance in situations where there are multiple shareholders, it may be prudent to place the insurance policies in a partnership made up of all the shareholders, providing for the distribution of any life insurance proceeds to the estate of a deceased shareholder.

If the value of the decedent's shares subsequently grows beyond the size of the insurance policy, the agreement should provide for the payout and terms of the remaining amounts due under the buy-sell agreement (generally under an installment plan). The life insurance agent who previously reviewed the insurance policies of the company and the shareholders will have the ability to propose the appropriate type of insurance, as well as the size of the death benefit necessary to fund the cross-purchase buy-sell agreement. Ideally, the company should be revalued every year so that the policies' death benefits are current, thereby negating the need for an installment note.

The shareholders must recognize that life insurance premiums are not a deductible expense. Rather, the business owners have the option to bonus the life insurance premiums to each of the shareholders who, in turn, will individually make the life insurance premium payments to the insurance company. The shareholders, however, must understand that the bonuses used to pay the insurance premiums will be included in wages on their individual tax returns.

It is not uncommon for business owners to object to picking up this tax liability. Therefore, the business, depending on its own cash flow requirements, may utilize a program known as "double bonusing" or "grossing up" the bonuses. By so doing, the business would make bonuses to the shareholders not only in an amount to cover the premiums to be paid under the life insurance policies, but also for the tax liability that the business owners would recognize on the amount bonused.

Disability Buyout Insurance

The death of a shareholder is only one of the triggering events that may cause a shareholder's interest to be bought out. Disability may also serve as a triggering event forcing a company to buy out a shareholder's stake in the company. Too often, shareholders overlook the concept of disability buyout insurance. Most business owners are familiar with the concept of disability insurance, and may have a policy that provides for all or part of their incomes to be paid by their insurance carrier during a period of disability. Few business owners, however, possess disability insurance that actually provides the company or nondisabled shareholders the economic means to acquire the shares of a stockholder-employee if such shareholder should become permanently disabled.

Disability buyout insurance is a unique insurance funding vehicle. It provides that upon the disability of a shareholder, as defined in the buy-sell agreement, the insurance is paid to the existing shareholders so that they have the funds to buy out the disabled shareholder's shares. Just as in funding the life insurance premiums, the shareholders must report the disability buyout premiums on their tax returns, and once more, the bonusing program discussed in the previous section is applicable.

Retirement

Shareholders must also provide a funding mechanism to buy out a retiring shareholder's interest in the company. Under a buy-sell agreement, the shareholders who are to remain may have the ability to buy out the retiring shareholder's interest by using a down payment of 10% or 20% and structuring the balance as an installment agreement to be paid over a period of years at an agreed-upon interest rate. However, they may also, through the use of life insurance, seek to provide a cash value that will build within the life insurance contract. Properly structured, the life insurance program may permit the remaining shareholders to borrow against the cash value in the life insurance policy and use those funds to help buy out the retiring shareholder's interest, in whole or in part.

However, a myriad of issues must be analyzed before buying life insurance to fund a buyout. Only after the team of advisers considers the following 15 issues can the structure of the buyout take shape:

1. What form of entity is involved—partnership, S corporation, C corporation, or limited liability company?
2. How many owners are involved?
3. How is the health of the owners?
4. What are the ages of the owners?
5. Do any of the owners plan on retiring within five years? Ten years?
6. Has a valuation of the business been completed?
7. Are the shares, units, or partnership interests owned equally?
8. Do the insurance illustrations project enough cash buildup for each owner to be bought out upon projected retirement dates?
9. Will the business bonus the premiums to the owners?
10. If premiums will be bonused, have potential inequities been addressed? For example, if shareholder A owns 80%, is 35 years old, and healthy, while shareholder B owns 20%, is 65 years old, and a smoker, does A object to the company bonusing out premiums to B?

11. If a buyout is contemplated for retirement, is the death benefit going to lapse or be purchased by the business, the insured, or other owners?
12. If the entity has three or more shareholders and one dies, becomes disabled, or retires, will the survivors need to recalculate their interests and adjust the insurance policies?
13. Are additional owners likely to join the entity?
14. Are any of the owners uninsurable?
15. Is disability buyout insurance to be purchased?

Only after the team of advisers together with the business owners have considered the issues may a determination be made as to whether the buy-sell agreement should be a cross-purchase, stock redemption, or wait-and-see agreement (allowing the shareholders to determine at the time of triggering event to either purchase the shares or have the company redeem them).

Valuation Updates

Finally, the shareholders must recognize that the value of their company changes from year to year. A common mistake in business succession planning is to complete the valuation and not revisit it again over subsequent years. Shareholders run the risk that several years later, when a triggering event occurs, the life insurance originally purchased does not reflect the value of the company at the time of the triggering event, which can only lead to disgruntled heirs and potential litigation. Accordingly, both the business owners and their advisers should annually update the business valuation, and alter life insurance used to fund the buyout accordingly.

CHAPTER 19

Transference of Business Interests

A number of factors should be taken into consideration when determining whether to make gifts of a closely held business interest to family members or other individuals. These factors include not only the typical tax, business, and other financial issues normally addressed in such circumstances but also the effect that such a gift or series of gifts will have on both the beneficiaries and the company.

The primary tax and business considerations include the donor's ability to reduce the size of his or her taxable estate for estate tax purposes, to provide for the orderly succession of the business to the next generation, and to ensure that any future appreciation in the business takes place in the name of the children and/or other family members rather than in the current owner's estate. However, nontax considerations, including the desire to provide the beneficiaries of such gifts with the incentive and opportunity to become involved in the operations of the company, are equally important.

Factors to Be Considered Before Gifting Company Stock

Making plans for the orderly transfer of control in a family business in a manner that both ensures the success of the business and fosters the personal growth of the successors should be of primary importance in determining when and to whom to make such gifts. A business owner should undertake a thorough in-depth analysis of the advantages and disadvantages associated with creating a gifting program of company stock. In this regard, the following factors should be considered before making a gift of company stock.

Reduction in Total Transfer Taxes

One of the most important reasons for considering the gifting of stock in a closely held family business is to enable the donor to reduce the ultimate estate tax liability.

Annual Gift Tax Exclusions

Each U.S. citizen may exclude the first $11,000 of gifts (other than gifts of future interests in property) made to any number of recipients during each calendar year. This annual exclusion is applied to all qualifying gifts to each recipient during the year in the order in which they are made until the $11,000 limit per person is exhausted. A gift tax return is required to be filed by an individual donor only if the annual gifts to any one person exceed $11,000 or if a husband and wife utilize gift splitting (as discussed in the following paragraphs). Thus, the owner of a closely held business may make annual gifts of up to $11,000 worth of stock per recipient without any gift tax consequences.

Furthermore, the advantages of annual-exclusion gifts can be doubled if the donor is married and both spouses utilize their annual exclusions. Each spouse can transfer separate interests in company stock or they can utilize gift splitting. Under gift splitting, the double exclusion can be obtained when one spouse owns and gifts all of the stock provided the other (nondonor) spouse consents to treat the transfer as if made one-half by each spouse.

A gift made by one spouse to any person other than the other spouse is considered made one-half by each spouse if both consent to split all gifts made by either while married during the calendar year. The effect of this provision is to permit one spouse to use the other's annual exclusion along with his or her own, thus increasing the annual exclusion from $11,000 to $22,000. Spouses may elect to split gifts only if both are citizens or legal residents of the United States. Gift tax returns may be required if gift splitting is utilized.

However, the utilization of the annual exclusion to facilitate the transfer of business interests must be made as part of one's overall gifting program. More specifically, one should determine whether the annual exclusion is required in any other facet of the estate plan such as irrevocable life insurance trusts, Section 529 plans, qualified personal residence trusts, or Crummey trusts.

Example

Husband owns 100% of the Puppy Company and wishes to transfer stock to his two children and four grandchildren. Husband, individually, could gift up to $66,000 (6 × $11,000) total each year. If wife consents to gift splitting, the couple, collectively, could gift up to $132,000 (6 × $22,000) of Puppy Company stock to be transferred gift tax free each year through the use of annual exclusion gifts.

Lifetime Gift Exemption

In addition to the $11,000 annual gift tax exclusion, the owner of a closely held company should also consider utilizing all or a portion of his or her applicable credit in order to gift larger amounts of company stock during his or her lifetime. The Internal Revenue Code currently provides for a lifetime exemption equivalent against gift tax of $1 million. Unlike the estate tax exemption, which increases to $1.5 million in year 2004, $2 million in 2006, and $3.5 million in year 2009, the lifetime gift tax exemption is fixed at $1 million.

Furthermore, if the business owner is married, the spouse's exemption equivalent can also be utilized, allowing a husband and wife together to transfer, in the years 2002 through 2004, $2 million of company stock (before utilizing any discounting techniques) to their beneficiaries without the imposition of federal gift taxes. If the lifetime gift exemption is to be utilized by the taxpayer during his or her lifetime, a gift tax return must be filed.

Removal of Posttransfer Appreciation

Once shares of stock have been transferred, all postgift appreciation (the appreciation that occurs after the gift of stock has been made) is removed from the donor's taxable estate. If the company then grows in value after the gift, all future appreciation of the gifted shares takes place in the estate of the beneficiary. So the donor removes from his or her estate tax base not only the value of the gifted shares but also all future appreciation in the value of the shares arising after the date of the gift.

Income Tax Savings

The donor can also achieve income tax savings by transferring shares of stock to his or her beneficiaries (who often are in a lower marginal income tax bracket than the donor). Thus, after the donor has transferred shares of stock to beneficiaries, all dividends and/or other distributions of income associated with such shares will be allocated to the beneficiaries, thereby reducing the taxable income of the donor.

Be aware, however, that if a beneficiary is younger than age 14, the "kiddie tax" may apply. This provision of the Code subjects a child under the age of 14 to taxes at the same rate as the parents, thus reducing the benefit of allocating income (and thus the income tax) to young children. However, once children reach the age of 14, they obtain their own tax brackets.

Capital Gains

In addition to removing the current income associated with such shares of stock from the donor's tax base, the removal of all future appreciation in the value of the gifted stock (both prior to and following the transfer) may also result in substantial tax savings for the donor. Under the Code, the recipient of a gift of appreciated assets generally takes the same tax basis as the donor. Thus, if the beneficiary of a gift of stock subsequently sells the stock, the gain is realized by the beneficiary and not the donor.

If the recipient subsequently disposes of the stock, he or she generally realizes the same amount of gain as would the donor. However, depending on the income tax bracket of the recipient, he or she may pay fewer taxes on the gain than would the donor.

Capital Losses

Although gains may be shifted from the donor to the recipient, losses may not be shifted. Loss basis rules set forth in the Internal Revenue Code operate to preclude the transfer of losses from a donor to a recipient. Under these rules, the recipient's basis in stock for determining losses is the lesser of the donor's basis in the stock or the fair market value of the stock on the date of the gift. If the stock has a fair market value at the time of the gift that is less than the donor's adjusted basis, the recipient's (donee's) basis is the fair market value at such time.

Ensuring Company Success

In an effort to reduce estate taxes, don't lose sight of the other goal of succession planning—business continuity. When structuring the gifting program, several issues must be addressed to help ensure that the gifting program is also in the company's best interest. The first issue is to determine whether the shares being gifted should be voting or nonvoting shares. If the shares gifted are voting, determine whether the child—who may become a swing vote—

has the mental maturity and financial sophistication to alter the course of the business for the better. If not, consider gifting nonvoting stock.

Many gifting programs utilizing the annual exclusion call for equal transference of stock to the children. However, if only one of the children is involved in the business, perhaps the participating child should receive voting stock, and the nonparticipating children should receive nonvoting stock. The key point is to gift shares of the business in a manner that reduces estate tax while simultaneously providing for the transition of leadership to help ensure the company's future success.

Willingness

Creating a business succession plan too often presumes that the child wants the shares. If a child has no interest in joining the family business, the shares could still be gifted but perhaps should be nonvoting shares given either outright or in trust for the child's benefit. If, on the other hand, the child is ready, willing, and able to join the family business, perhaps the transference of stock should be completed during an apprentice period. Accomplishing the transfer of stock via the annual exclusion could foster this phasing-in concept.

Many businesses operate with bank credit lines or where the principals have personally guaranteed obligations of the company, including leaseholds. Whatever the potential liability may be, beware of transferring stock to children without first discussing the pros and cons of the transfer. Many businesses have risk, and the company should want only those who are willing to embrace the risk to share, hopefully, in the eventual reward.

Equality

If one child is involved in the family business and the others are not, should shares be gifted equally among all of the children? If so, in the event that the business dramatically appreciates due to the participating child's blood, sweat, and tears, then the other children will share equally in the success of the business. Is that equality? While there exists no one right way to address this issue, several options are available.

Perhaps the nonparticipating children should be beneficiaries of a life insurance trust having a death benefit equal to the value of the shares gifted to the participating child. Alternatively, cash or securities could be gifted to the nonparticipating children instead of the business interest. Communication, teamwork, and flexibility combined with a sensitivity to the issues will help ensure that equality, if not achieved, was at least sought.

Enhanced Estate Liquidity

Estates of significant value often are exposed to hardship because the major assets of the estate may be illiquid, such as shares of stock in a closely held business. When the owner of a company dies, the estate may be liable for numerous expenses, including substantial estate taxes. To avoid the problem of leaving an estate consisting primarily of illiquid assets such as closely held stock, the gifting of stock during one's lifetime serves two purposes:

1. It reduces the value of the estate by the value of the stock when gifted (as well as any postgift appreciation in the stock gifted).
2. It increases the percentage of liquid assets in the estate as compared to the illiquid assets (such as any shares of stock remaining in the estate of the deceased shareholder following such gifts).

This analysis should be carefully considered in light of certain postmortem planning techniques available to the heirs of one's estate.

Planning for Control of Family Business

Providing for an orderly transfer of control in a closely held business is an important issue to be addressed when preparing the estate plan of an owner of a family business. If a person owns a successful business, the estate tax due upon death may be substantial. Furthermore, distribution of the ownership interests in the business after the person's death may generate disagreement among the beneficiaries if control of the business was not prescribed by the decedent prior to death or through a will. Thus, the owner can avoid many potential family problems by initiating a plan for the transfer of a controlling interest in the company to the children intended to run the business after the business owner is gone.

Example

Gary and Leslie are the sole owners of stock in a closely held corporation. The value of the stock constitutes one-half of their estate; the other half consists of marketable securities. The couple has four children, two of whom have worked in the business for several years and have expressed an interest in continuing the business following the retirement of their parents. The other two have no interest in the business.

Gary and Leslie would like to transfer control to the two children involved in the business and give the rest of their property to the other two children.

Lifetime gifts may be used to start the process of transferring both types of assets in an orderly fashion, as well as reducing the size of their estate for estate tax purposes.

For instance, one method would be for Gary and Leslie to maximize use of their exemption equivalent to transfer shares in the company to the two children interested in running the business after their parents are gone, and then provide an equalization clause in their wills to make up any difference to the two children not interested in running the business. Such a strategy would have the effect of increasing the liquidity of Gary and Leslie's estate and help prevent the need to liquidate the company to pay estate taxes.

Loss of Step-Up in Basis

As mentioned earlier, the Internal Revenue Code generally provides that the recipient of a lifetime gift inherits the tax basis in transferred property equal to the donor's basis (a "carryover basis" in the property). The Code also provides, however, that the tax basis of property received from a decedent at death equals the fair market value of the property on the date of death ("stepped-up basis"). Any appreciation in the value of property gifted before death is not eligible for this step-up in basis.

The loss of the stepped-up basis resulting from making lifetime gifts rather than postdeath transfers is an important factor to consider when determining whether to make lifetime gifts of company stock. However, currently the top marginal federal income tax rate on long-term capital gains is 20%, whereas the top federal estate and gift tax rate is 50%. This differential in capital gains versus estate tax rates should be carefully analyzed by business owners and their financial and tax advisers before determining whether lifetime gifts make economic sense.

As has been stated throughout this book, all estate and business succession planning must be performed with one eye on Congress. Under the terms of the Economic Growth and Tax Relief Reconciliation Act of 2001, the estate tax is due to be phased out over the next eight years. If this phaseout were ever actually to take place, the current estate tax system, which provides for the step-up in basis of the assets of a decedent, would be replaced by a carryover basis system in which generally (with certain limited exceptions) all assets of a decedent would retain their historic bases. Thus, the basis differential between lifetime gifts and gifts at death set forth before would be lost. The only exception is if you were to use company stock to take advantage of the $3 million step-up in basis to a spouse or the $1.3 million step-up for gifts to persons other than a spouse. Accordingly, if you have started a lifetime gifting program involving equity interests in the family business and repeal actually does take place, the generally accepted downside of such a gifting program (i.e., loss of step-up in basis) would no longer exist. Thus, it is even more economically imperative that you start such a program, or continue such a program if already started, in the face of estate tax. There is little, if any, downside.

Loss of Control over Property

After the stock has been transferred outright, free of trust, the donor no longer has any ownership rights. Furthermore, if the transferred property is income producing, the income no longer belongs to the donor. Without any of the planning structures discussed in the chapters to follow, the IRS may deem a transfer to be incomplete if the donor is able to control the property or treats it as his or her own following such a transfer. Thus, when making lifetime gifts it is imperative that donors relinquish control over the gifted shares and no longer treat them as their own.

Methods of Transfer

Once a determination has been made that a business succession plan must be implemented, the method of transferring the interest must be considered. The following techniques are available for this purpose:

- Outright transfer of voting stock.
- Outright transfer of nonvoting stock.
- Family limited partnership (see Chapter 21).
- Grantor retained annuity trust (see Chapter 22).
- Grantor retained unitrust (see Chapter 22).
- Intentionally defective grantor trust (see Chapter 23).
- Self-canceling installment notes (see Chapter 25).
- Private annuities (see Chapter 25).
- Trusts, including specifically qualified subchapter S trusts (QSSTs) and electing small business trusts (ESBTs).
- In the case of failure to implement a gifting program during one's lifetime, partial tax relief under IRC Sections 6166 and 303.

Qualified Subchapter S Trust

A trust can serve as a shareholder in an S corporation provided it satisfies the requirements of a qualified subchapter S trust (QSST). A QSST can have only one current income beneficiary, and all income earned by the trust must be distributed currently to the beneficiary. If the trust fails to meet this income distribution rule, the status of the trust as a QSST terminates on the first day of the next taxable year after such disqualifying event occurs. Furthermore, any principal distributed by the S corporation during such beneficiary's life must also be distributed to that beneficiary. If the trust terminates during the current income beneficiary's life, the trust assets must be distributed to such beneficiary. Upon the death of the beneficiary, a QSST must terminate and distribute all of its assets to the beneficiary's estate. The beneficiary of a QSST must be a U.S. citizen or resident, and must cooperate in the planning since the election to treat a trust as a QSST can only be made by such beneficiary. The election, once made, is irrevocable.

Failure to qualify the trust as a QSST—or as an electing small business trust (ESBT), as discussed in the next section—can have dire consequences to the status of the corporation as an S corporation. If a trust owning stock in a corporation fails to so qualify, the corporation will not qualify as an S corporation and will lose its ability to flow through profits to its shareholders. Instead, the corporation will be subject to taxation as a separate legal entity (i.e., a C corporation). Without proper planning, such a result can have adverse consequences on both the corporation and its shareholders, including the trust established as the gifting vehicle for all or a portion of the stock.

Electing Small Business Trust

In 1996, seeking to provide more planning opportunities for S corporations, Congress created the electing small business trust (ESBT), which can also serve as a shareholder of an S corporation. The trustee of an ESBT must file with the Internal Revenue Service an election for the trust to be an ESBT.

Unlike a QSST, an ESBT can provide for multiple beneficiaries and discretionary payments of income between the multiple beneficiaries, as well as between future unborn beneficiaries. A trust can qualify as an ESBT if no interest in the trust was acquired by purchase and all of the beneficiaries are either individuals or estates that would otherwise qualify as S corporation shareholders (except charitable organizations, which may hold contingent remainder interests as well as current interests in the trust). However, unlike a QSST, the portion of the ESBT consisting of S corporation stock is treated as a separate trust, subject to income tax at the highest individual rate in effect at the time.

In determining the tax liability with regard to the remaining portion of the trust (if any), the income from the S corporation stock is ignored. Although distributions from the trust on this portion are deductible in computing the taxable income of the trust, none of the income generated by the S corporation stock held by the trust is deductible. Thus, without careful planning, an ESBT can prove to be a highly inefficient vehicle for holding S corporation shares for income tax purposes. As a new type of planning vehicle, the ESBT provides more flexibility than a QSST, but the decision to use an ESBT must be carefully considered and analyzed.

Failure to Implement Gifting Program During One's Life—Partial Tax Relief Under Code Sections 6166 and 303

Even if you have failed to implement any of the previously referenced gifting techniques during your life, the IRS provides certain estate tax relief. If more than 35% of your estate consists of at least a 20% ownership interest in a closely held business, your executor may make a timely filed election under Section 6166 of the Internal Revenue Code to defer the payment of estate taxes applicable to such interest for a period of up to 14 years. If gifts were made within three years of death, this business interest must meet the same 35% test after adding such gifts back into the estate for purposes of making the computation.

Prior to the 2001 Tax Act, Section 6166 treatment was available only if such company had 15 or fewer partners or shareholders. Under the 2001 Tax Act, the number of business owners has been increased from 15 to 45. If Section 6166 is elected on a timely filed estate tax return, the portion of the estate tax liability due to the small business interest may be paid in up to 10 installments, with the first installment due no later than five years and nine months after the owner's death. However, during the period of deferral, interest must be paid annually (although at a favorable 2% annual interest rate) and the executor remains personally liable for the estate tax during the entire period of deferral. Any interest paid on such deferral cannot be deducted against the estate for estate tax purposes.

Furthermore, under Section 303 of the Internal Revenue Code, the redemption of stock to make payments of estate tax will not be treated as a dividend taxable to the estate as ordinary income, provided any such amount is actually utilized to pay estate tax liability and/or financial or administrative expenses of the estate. Absent Section 303, such redemptions would be treated as dividend income unless such redemptions generally resulted in the termination of the decedent's (and his or her entire family's) interest in the company. With

Section 303, there is rarely any tax on such redemptions because the stock being redeemed receives a step-up in basis so that the only taxable gain on a redemption of stock to pay estate taxes results from an increase in the value of the company following the death of the owner. Redemptions under Section 303 must generally be made within three years of the assessment of estate taxes against the estate of the deceased company owner. However, if the estate has made a timely filed Section 6166 election, these redemptions can be made during the time established for the payment of the installments set forth in the Section 6166 election.

Conclusion

Frequently, numerous techniques are utilized in conjunction with each other in an effort to meet multiple objectives, such as to help secure the retirement needs of a business owner, hedge against the risk factor of each tool, transfer the business interest over time, reduce estate tax, protect the gifted interest from claims of creditors, maintain equality, and provide for the transition of leadership over time. Accomplishing all of these objectives is a delicate balance requiring skill, patience, teamwork, and commitment.

CHAPTER 20

Family-Owned Business Deduction

Introduction

Recognizing that family businesses are an integral part of the U.S. economy, Congress sought to provide estate tax relief for family business owners as part of the Taxpayer Relief Act of 1997. Prior to the enactment of the 1997 Act, however, there were discussions about completely exempting certain family-owned businesses from estate taxation, which was then watered down to a fixed $750,000 exemption from estate taxes for certain family businesses. This exemption amount was then further watered down to produce the Taxpayer Relief Act of 1997, as further revised by the Revenue Reconciliation Act of 1998.

The qualified family-owned business (QFOB) deduction has unfortunately provided little relief for small business owners, is difficult to implement, and places a heavy compliance burden on the survivors for years after the owners' deaths. Accordingly, while it is a tool available to help offset the estate tax attributable to a family-owned business, proactive planning outside the use of the family-owned business deduction is generally more advantageous than passively relying on the QFOB deduction with all of its associated complexities and qualifications.

The new 2001 Tax Act repealed the qualified family-owned business deduction for all estates where death occurs after December 31, 2003. Providing relief to business owners was a great idea, but the relief provided in the form of the QFOB deduction was a failure, and under the new act the deduction is repealed effective December 31, 2003. Until then, however, the supposed relief is available, and the mess Congress created is summarized next.

Deduction Amount

The first objective in trying to understand the QFOB deduction is to discern the actual amount of the deduction that is available. The QFOB deduction is limited to $675,000. The exemption equivalent is limited to $625,000, if the deduction is fully elected. If, however, the entire $675,000 QFOB deduction is not utilized, a greater amount of the exemption equivalent may be used. Accordingly, if all of the onerous QFOB requirements are met, the total amount that can be sheltered is $1,300,000. Even in year 2006, the applicable credit will still be $202,550 (exemption equivalent of $625,000) and the maximum QFOB remains at $675,000.

Initial Qualifying Rules

However, several complex requirements must be met before a family business will qualify for the QFOB deduction. The first requirement is that the decedent must be a citizen or resident of the United States at the time of death. Additionally, the principal place of the business of the family-owned company must be in the United States.

The 50% Test

Furthermore, the value of the decedent's interest in the qualified family-owned business must exceed 50% of his or her adjusted gross estate. In computing the value of the decedent's adjusted gross estate, you must start by calculating the decedent's gross estate, reduced by estate tax deductions and other claims against the estate (including debts) increased by certain gifts made by the decedent prior to death. These gifts include:

- Family-owned business interests that the decedent gave to family members and that are still retained by these family members at the time of the decedent's death.

- Gifts to the decedent's spouse during the 10-year period preceding the decedent's death (minus any gifts included in item 1).
- Gifts within three years prior to death (other than annual exclusion gifts).

Existence of Trade or Business

In making the determination as to whether a business qualifies for the family-owned business deduction, the business must first qualify as a trade or a business under the Internal Revenue Code. Excluded from this definition are passive assets, which include: (1) assets producing interest, dividends, rents, royalties, annuities, and other personal holding company income; (2) net gains from assets that are interests in a trust, partnership, or real estate mortgage investment entity that do not constitute an active trade or business; (3) net gains from assets producing no income; (4) assets giving rise to income from commodity transactions or foreign currency gains; (5) assets producing interest-like income; and (6) assets producing income from notional principal contracts or payments in lieu of dividends.

This passive asset test must be met at the time of the decedent's demise and during the postdeath 10-year recapture period following the decedent's death (other than a two-year window immediately following death). Although there is not a concise definition of what a trade or business is, the term was intended to require continuity and regularity of activity in which the owner or owners carry the risk of production and the risk of price change.

Once it is determined that the decedent was a U.S. citizen, that the family business's principal place of business is within the United States, that the value of the family-owned business exceeds 50% of the gross estate, and that the business is not deemed to be a passive entity, the next test is the ownership test.

Ownership Test

A qualified family-owned business interest includes an interest as a proprietor or an interest in an entity carrying on a business if at least 50% of the entity is owned directly or indirectly by the decedent or a member of the decedent's family. An interest in a business will also qualify as a family-owned business interest if at least 70% of the entity is owned by members of two families, and at least 30% is owned by the decedent or the decedent's family. Similarly, an interest qualifies as a family-owned business interest if 90% of the entity is owned by members of three families and at least 30% is owned by the decedent or the decedent's family.

Qualified Heir Test

Even if the value of the decedent's interest in the family-owned business exceeds 50% of the decedent's adjusted gross estate, it will qualify under the family-owned business deduction only if it, in fact, passes to the decedent's heirs at the time of death.

Furthermore, the interest being passed to a family member must be to a "qualified heir." Qualified heirs are the eligible individuals who may receive an interest in the closely held business in order for the family-owned business to qualify for the deduction. The term is defined as (1) members of a decedent's family who acquired the property or who received the property pursuant to the decedent's last will and testament, and (2) active employees of the trade or business to which the qualified family-owned business relates if they had been employed by such trade or business for at least 10 years before the decedent's death.

The term "member of family" is a term of art having a specific definition. That definition includes: an individual's spouse; lineal decedents of the individual, the individual's spouse, and the individual's parents; as well as the spouses of lineal decedents. However, in order for these family members to qualify for the family-owned business deduction, the decedent's family must have materially participated in the trade or business for at least five of the eight years immediately preceding the decedent's retirement, disability, or death. Additionally, the decedent or at least one member of the decedent's family must have owned the family business interest or interests for five or more of the last eight years prior to the decedent's death.

Material Participation

What is material participation, you ask. While there is no one test in determining what material participation is because material participation may mean different things for different businesses, generally it is considered physical work or participation in the management decisions of the business. This is a nebulous term at best, which will undoubtedly result in numerous differing interpretations (and probably much litigation).

Recapture Rules

In the event that the decedent's heirs have made it through the labyrinth of rules set forth so far, they are still not done. A number of events will trigger a recapture tax and reverse the benefits derived from qualifying the business as a family-owned business at the time of the decedent's death.

If the qualified heirs or members of the qualified heir's family cease to materially participate in the closely held business for more than three years during the eight-year period following the decedent's death, the recapture rules are triggered. The recapture rules will also be triggered if the principal place of business ceases to be located in the United States or if any qualified heir loses U.S. citizenship.

Another event that triggers recapture is if the family-owned business fails to pass the passive asset test or if an increase in the amount of passive assets after the decedent's results in the business no longer being treated as a "trade or business" under the applicable Internal Revenue Code provisions.

But perhaps the biggest burden for the qualified heirs or family members is the restriction that the business cannot be sold during the 10-year period following the decedent's death.

If any of the events set forth take place, triggering the recapture rules, estate taxes plus interest will be due in the following percentages:

Year	Recapture Percentage
1–6	100%
7	80%
8	60%
9	40%
10	20%

Conclusion

One would need a crystal ball to determine whether a qualified heir or family member would remain actively involved in a family business 10 years after a parent's demise. In light of the fact that the qualifying rules for meeting the stringent requirements of the qualified family-owned business deduction are so complex and onerous, combined with the fact that upon the decedent's demise these recapture rules loom large, it is hard to get excited about the family-owned business deduction. The deduction will be repealed as of 2004.

The burdens viewed in conjunction with the few benefits of the family-owned business deduction lead most commentators to conclude that the family-owned business deduction is not a technique that you, the business owner, should plan for (although you may be fortunate enough to fall into it). If a business owner fails to proactively create a business succession plan, and if upon his or her demise (on or before December 31, 2003) all of the family-owned business deduction requirements are met, and if during the subsequent

10 years the recapture rules are not triggered, then the family-owned business deduction offers some relief from estate taxation, although it is doubtful.

Recognizing that the original goal of the legislators was to provide estate tax relief for family business owners, the family-owned business deduction legislation has fallen short of its goal. Accordingly, if it is your intention to preserve your family business for future generations, you should plan proactively during your lifetime and not rely on the family-owned business deduction.

CHAPTER 21

Family Limited Partnerships

Introduction

Question: What wealth transference technique allows parents to:

- Gift as much as 99.9% of an asset (or assets) to their heirs or other beneficiaries?
- Retain control of the assets gifted?
- Discount the value of the gifts for gift and estate tax purposes?
- Retain control of the flow of income from the assets gifted?
- Maintain flexibility in structuring the form of the gift and the timing of the gift?
- Protect the assets gifted from claims of creditors?
- Promote continuity of management to accomplish a business or other succession plan?
- Reduce the inevitable estate tax burden?

Answer: The family limited partnership (FLP).

This chapter's discussion is limited to family limited partnerships (or FLPs). However, family limited liability companies (FLLCs) are becoming increasingly popular because of their asset protection attributes and can be used in many instances in lieu of family limited partnerships. An FLLC is established in much the same way as an FLP but is treated, for liability purposes, similar to a corporation, thus insulating all of the individual members from any liabilities of the FLLC.

Truly one of the estate planner's most powerful tools, the family limited partnership merits consideration in almost every high-net-worth estate and business succession plan. As this technique incorporates the principles of gift tax planning, estate tax planning, valuation discounts, and creditor protection all rolled into one ongoing strategy, the team approach is a must. While the cost to create and maintain a family limited partnership is not insignificant, the upside far outweighs the cost.

By conveying a family business or portfolio of family investments to a family limited partnership, the senior members of a family can share the value of their assets with their heirs while simultaneously maintaining control over the assets and lowering both their income taxes and their estate taxes. In addition, a family limited partnership can be an effective tool for introducing the younger members of a family to the family business or investment portfolio while limiting much of the downside risk generally associated with handing over the reins of the operation of such business or portfolio to other members of the family.

The use of a family limited partnership generally consists of two steps: (1) one or both parents create the partnership and serve as the general partner(s) of the partnership (either directly or through a wholly owned corporation or limited liability company), and (2) the parents then gift limited partnership interests to their children and/or grandchildren, who then serve as the limited partners. Initially, one or both parents hold both the general partnership and the limited partnership interests. The general partnership interest(s) can consist of as little as .1% of the total equity in the partnership assets with the limited partnership interests (which can be divided into a large number of units) accounting for the remainder of the equity in the partnership assets. The parents retain the general partnership interest(s) for an indefinite period of time and systematically assign the limited partnership interests to their heirs.

Who Controls the Partnership?

While holding as little as .1% of the equity in the partnership, the parents, as the sole general partners, can maintain full and complete control over the business or investments held by the partnership while gifting as many of the limited partnership units to their heirs as they desire. Thus, the parents can successfully shift much of the value of their assets to their children and/or grandchildren (thus reducing estate and income taxes) without giving up control of the assets inside the partnership.

Assume, for instance, that the parents have a large parcel of commercial real estate they wish to transfer out of their combined taxable estates. The net fair market value of the property is $1 million. The parents are interested in utilizing their $11,000 annual gift tax exclusions to provide gifts of a portion of the real estate to each of their three children. If they had to make gifts of the real estate outright, they would have to deed fractional interests to their children, a costly, time-consuming, and administratively burdensome affair.

In the alternative, the parents could contribute the real estate to a family limited partnership. The parents would serve as the general partners of the partnership, initially owning all of the general and limited partnership interests. They could then gift the limited partnership units to their children over a period of years, using their $11,000 annual gift tax exclusions. (The parents would combine gifts in order to give each child $22,000 worth of limited partnership units each year.)

To accurately reflect the value of the annual gifts, it is necessary to appraise the property owned by the partnership, then transfer that portion of the partnership interests to each of the children which accurately reflects the $11,000 (or $22,000 combined) annual gift. Assuming a value of $1 million (which remains constant over the gifting period), the parents could gift limited partnership units to their three children (valued at $66,000 per year) and remove the entire $1 million value from their taxable estates over a 16-year period without ever losing management control over the real estate. Alternatively, they could take advantage of a portion of each of their exemption equivalents ($1 million in year 2002 for a combined exemption equivalent of $2 million) to gift all of the limited partnership units in one year (a technique that can be beneficial in situations where the partnership assets are appreciating rapidly).

Discounting the Value of the Limited Partnership Interest

Furthermore, because the children do not control the operations of the partnership and do not have the right to assign their interests in the partnership without the general partners' consent, the parents are able to gift even more than $22,000 worth of assets each year by utilizing the limited partnership structure. For example, the net value of the property contributed to the family limited partnership outlined in the previous section is $1 million. However, the value of the limited partnership interests gifted to the children may be reduced or "discounted" since, as limited partners, they cannot vote, freely sell their shares, or participate in the decision-making process. Even if the limited partners have the right to sell their interests, generally there is no ready market to buy limited partnership interests in the family partnership (as is the case with publicly traded securities).

Each family limited partnership has its own unique characteristics, whether it is the property contributed to the partnership or the family members who participate in its administration. Accordingly, the following two discounting techniques must take into consideration the unique qualities of each partnership before the valuation expert or accountant can determine the appropriate discount for transferring limited partnership interests. Furthermore, as discussed in Chapter 16, these are not the only discounts available to the business valuation expert. (See, for example, the key manager and investment company adjustments set forth in Chapter 16).

1. *Minority interest discount.* Limited partners are prohibited by law from participating in the daily operations of a partnership. They generally may not appoint managers, decide on the future direction of the partnership, declare distributions, determine compensation, or force liquidation or sale of the underlying assets. Both the IRS and the courts have recognized that a minority interest ownership position such as a limited partnership interest is worth less than a proportionate percentage of the underlying assets because of this lack of control over the operations of the partnership. Not having direct access to the underlying assets of the partnership or the ability to control those assets allows for a discount when gifting limited partnership interests in the family partnership.

2. *Lack-of-marketability discount.* Another factor to consider in valuing limited partnership interests is the lack of marketability for such interests. Unlike a publicly traded security, there exists no ready market for limited partnership interests. Furthermore, in the context of a family limited partnership, the partnership agreement will generally provide additional restrictions on the transferability or disposition of limited partnership units, such as the right of first refusal by the general partners or an outright prohibition on the transferability of partnership interests without the general partners' consent. Thus, the limited partners' interests in the partnership should be assessed at an additional discount to reflect this lack of marketability.

The combined discounts for minority interests and lack of marketability can reduce the value of the limited partnership interests in a family limited partnership by as much as 20% to 50%, depending on the circumstances. Consequently, a larger percentage of the net equity of a family limited partnership can be gifted utilizing the annual gift tax exclusions and the applicable credits of the parents.

For instance, in our example, if the parents were advised to use a 33% combined discount for lack of marketability and lack of control, they could gift limited partnership interests that correspond to $33,000 worth of the underlying real estate ($33,000 discounted by 33% equals $22,000) to each of their three children, or $99,000 worth of real estate held in the family partnership each year, without any gift tax consequences. This would enable them to give away the entire value of the $1 million parcel in 10 years (as opposed to 16 years without discounting) utilizing only their combined $22,000 annual gift exclusions.

In the alternative, the parents could utilize a portion of their combined applicable credits to gift all of their limited partnership units in one year, using only $700,000 of their combined credits. In fact, in 2002, by utilizing only the couple's combined $2 million exemption equivalent and taking advantage of a 33% combined discount, the parents could remove $3 million of assets from their combined estates in a single year.

Since the value of property varies from year to year, it is important to review the value of the limited partnership interests on a periodic basis if annual exclusion gifts are being utilized. This exercise must be performed prior to making any gifts intended to qualify for the $11,000 annual gift exclusion or the applicable credit. Also, the amount of discounting available may be affected by the type of property owned by the partnership. If the partnership owns mostly marketable securities, the discounting allowable for the partnership units will usually be less than if the partnership owns primarily illiquid assets such as real estate. If the partnership owns a closely held business or a parcel of real estate, the discounts applied to the partnership units will most likely be higher.

Should You Form an Entity to Serve as the General Partner?

If the parents' intent is to direct the future control over the family assets placed into the partnership, they may do so by stating in their wills the disposition of the general partnership interests. Under state law, the death or bankruptcy of a general partner usually terminates a partnership (although the partnership agreement may permit a majority of the remaining partners to vote to continue the partnership if a general partner dies). Therefore, if the parents act as general partners in their individual capacities, there may be some limit on the ability of the partnership to continue. Accordingly, they may want to consider structuring the limited partnership with a corporation or limited liability company (LLC) as the general partner.

Instead of owning the general partnership interest individually, the parents can form a corporation or LLC to hold the general partner's interest. The parents would own the stock or membership interests in the general partner entity. Then, upon the death of either parent, the partnership would not terminate. This way, the parent(s) could direct future control of the business after they are gone by leaving the stock or membership interests to the particular family members they choose to run the business or manage the assets placed in the partnership. This may enable the parents to distribute the assets of their estates equitably to a group of children while still allowing them to vest control in one or more children who have expressed an interest and a willingness to continue to manage the assets held by the partnership.

Asset Protection

Another attractive feature of the family limited partnership is the ability to protect the partnership assets from the children's creditors, spouses, or other persons who may have claims against their assets. For instance, if any of the children were to declare bankruptcy or be put into receivership, the creditors would be severely limited in their ability to attach any of the partnership assets. The creditors could not order the liquidation of the partnership, disposition of partnership assets, or partition of any part of the partnership assets.

Often, the best result a creditor can expect is merely the right to receive distributions attributable to the limited partnership units owned by the debtor child, but only if and when any such distributions are made by the partnership. The parents, as the general partners (or owners of the entity serving as the general partner), have a great deal of control over the amount and timing of these distributions. As a result, creditors are hesitant to take partnership units that could result in their receiving "phantom" income for federal income tax purposes and no cash to pay the tax liability. Such limitations may facilitate the child's ability to reach a favorable settlement with creditors.

Furthermore, a limited partnership agreement can protect the integrity of a family business by giving the partners or the partnership the right to acquire the interests of any bankrupt or divorced partner. This may generally be accomplished by permitting the partnership itself or the other partners the right to acquire any assets that might otherwise fall into the hands of an outsider.

Conclusion

A family limited partnership can provide numerous benefits for both tax and business reasons. This is particularly true in light of the major revisions to the estate tax system under the terms of the Economic Growth and Tax Relief Reconciliation Act of 2001 (and even under the remote possibility of repeal in 2010). In fact, because of their almost limitless flexibility in both income and estate tax planning, family limited partnerships remain one of the most valuable tax planning tools available to taxpayers today (and will continue to remain so for years to come). However, the issues involved in establishing such an entity are numerous and complex. Accordingly, anyone considering setting up a family limited partnership should always consult his or her team of advisers in order to properly implement the techniques described in this chapter.

CHAPTER 22

Grantor Retained Annuity Trusts and Grantor Retained Unitrusts

Introduction

Creating effective estate plans for high-net-worth, high-income individuals many times requires the use of more sophisticated estate planning tools. Such tools often rely on two basic estate planning concepts: the use of valuation discounts and the leveraging of gift transfers.

The use of these two estate planning concepts is particularly effective in the case of individuals whose net worth is concentrated, to a great extent, in privately held businesses such as real estate or closely held companies. Generally, the desire of such individuals is fourfold: (1) to continue to control their interests in such assets for as long as possible, (2) to enjoy the cash flow resulting from their assets, (3) to transfer assets eventually to their loved ones, and (4) to minimize estate taxes.

The use of a grantor retained annuity trust (GRAT) or a grantor retained unitrust (GRUT) may provide a solution to these seemingly contradictory objectives. By utilizing a GRAT or GRUT, an individual can retain control over assets for as long as possible, still enjoy the future income from such assets, and simultaneously transfer the assets to his or her heirs with a minimum of estate and gift taxes.

What Is a GRAT?

The underlying structure of a GRAT is relatively simple. The grantor (1) establishes an irrevocable trust, (2) transfers certain assets to the trust, (3) retains an interest in the trust for a defined period of time, and (4) transfers the trust assets to the intended beneficiaries (generally the grantor's children or heirs) at the end of the trust term. The grantor retains the right to a fixed annuity for a term of years, at the end of which the trust assets (as well as any appreciation) pass directly to the beneficiaries or to a continuing trust for their benefit.

The benefit of a GRAT from an estate and gift tax perspective is that the value of the gift to the beneficiaries is reduced by the present value of the annuity payments retained by the grantor. Thus, if the grantor gifts the remainder interest in certain assets, yet retains an annuity interest in the assets, the value of the gift is discounted according to certain actuarial tables established under the Internal Revenue Code. These tables are published by the IRS on a monthly basis and provide an interest rate based on the applicable federal rate for a mid-term debt instrument (three to nine years) multiplied by 120%.

Under the Treasury regulations, the trust instrument establishing the GRAT must set forth a fixed term of years and the specified annuity amount, payable at least annually to the grantor. The longer the term and the greater the annuity amount due the grantor, the smaller the gift and consequent gift tax liability due on the gift to the ultimate beneficiaries.

Therefore, the life expectancy of the grantor is critical when determining the likelihood of the GRAT running to term. If the grantor dies during the term of the GRAT, the entire value of the assets held in the trust is pulled back into his or her estate and is subject to full estate taxation. Thus, the term of the trust must be carefully established so that the grantor's odds of surviving the term are favorable. Even if a 70-year-old grantor is in good health, it may be imprudent to establish a GRAT with a term of 10 years, whereas if the donor is 60 years old a GRAT of 10 or even 15 years may be statistically prudent.

A grantor can also establish several GRATs of varying terms (sometimes referred to as "tiered GRATs"). For instance, a grantor could establish three separate GRATs of 5, 7, and 10 years. If the grantor then lived for 7 years after establishing such tiered GRATs, even though the assets in the 10-year GRAT would be pulled back into his or her estate, the assets (as well as any appreciation) in the 5-year and 7-year GRATs would have been successfully removed from the grantor's taxable estate.

A grantor should avoid utilizing a GRAT that may benefit grandchildren. Under the generation-skipping transfer tax provisions, interests in a GRAT are not deemed to be gifted at the time of the establishment of the GRAT. Rather, if the grantor dies prior to the GRAT term, the full value of the trust corpus is included in the grantor's estate, and if the beneficiaries are skip persons, the gift will be treated as a generation-skipping transfer upon termination of the GRAT. (See Chapter 8, "Generation-Skipping Transfer Tax.")

What Is a GRUT?

There are certain situations in which a grantor retained unitrust (GRUT) may serve as a more effective transfer technique than a GRAT. Under the terms of a GRUT, the grantor retains a fixed percentage of the trust corpus, as opposed to a fixed annuity interest as in the case of a GRAT. This type of arrangement requires the revaluation of the trust corpus on an annual basis, with a fixed percentage of the trust (e.g., 7%) payable to the grantor annually (or more frequently) regardless of the amount of income actually earned by the trust.

GRAT or GRUT—Which One Should You Choose?

When determining whether to use a GRAT or a GRUT, one thing to be aware of is that a GRUT will generally produce a lower remainder value than a GRAT if the annuity payout rate is less than the applicable federal rate. However, a GRAT will produce a lower remainder value than a GRUT if the annuity payout rate is greater than the applicable federal rate.

Also, with the use of a GRAT, the assets need to be valued only once (at the time they are placed into the trust). With a GRUT, the assets need to be valued each year. This annual revaluation may prove impractical and cost-prohibitive if the assets placed in the GRUT consist of real estate or equity interests in a closely held business. As a result, the use of a GRAT, rather than a GRUT, will generally be less expensive from an administrative standpoint.

In the case of either a GRAT or a GRUT, the grantor cannot retain an interest in "all income earned by the trust." Such a right to all of the income would result in the beneficiaries' interest being valued at zero and the full value of the trust corpus retained in the grantor's estate.

Assets to Be Placed in the GRAT or GRUT

A potential grantor can place almost any type of asset in a GRAT or a GRUT. However, interests in real estate or a closely held business have proven to be the most effective for purposes of reducing estate and gift taxes because of the use of minority and marketability discounts.

Real Estate or Fractional Interests Therein

Assume a potential grantor owns an apartment building valued at $1 million which generates $100,000 of cash flow per year. Assume further that the grantor creates a GRAT for 10 years, reserving $100,000 per year as an annuity payout. If the statutory rate is 8%, the value of the retained annuity interest is $608,110, and the gift will be equal to $1,000,000 minus $608,110, or $391,890. Thus, by creating a GRAT, the grantor is able to accomplish the following three goals:

1. The grantor retains the cash flow for a period of 10 years.
2. The grantor maintains control over the property as the GRAT trustee.
3. The grantor is able to remove the $1 million property from the estate, plus all its future appreciation, for a gift valued at $391,890, which can be offset through the use of the grantor's exemption equivalent.

For purposes of further leveraging the value of the GRAT, the grantor can contribute a fractional interest in the real estate rather than contributing the grantor's entire interest in the real estate. This technique may help justify a discount for the value of the fractional interest prior to valuing the retained interest for purposes of establishing the value of the gift portion of the GRAT. Fractional interests in real estate may be discounted, since a fractional interest in real estate is valued at less than the corresponding percentage of the entire parcel of real estate. However, the transfer of a fractional interest in real estate requires re-deeding the property and possibly subdividing the real estate, and could require zoning approval and additional costs in certain situations. Accordingly, careful analysis should be undertaken before considering the placement of fractional interests of real estate in a GRAT.

Family Limited Partnerships

One alternative to transferring fractional interests of real estate or other assets into the GRAT would be to create a family limited partnership. The grantor could then increase the leverage of the gift by transferring the assets into the family limited partnership and then transferring limited partnership interests into the GRAT. As discussed in Chapter 21, the value of a limited partnership interest in a family limited partnership may be reduced due to its lack of marketability and lack of control over the operation of the partnership. Thus, by transferring limited partnership interests into the GRAT, the grantor can take advantage of these discounts, further leveraging the value of the gift prior to transferring the asset into the GRAT, while simultaneously retaining control over the property through retention of the general partnership interest even after the end of the trust term.

Closely Held Business Interests

The owner of a closely held business can transfer a minority interest in the business to a GRAT and retain an annuity interest, thereby transferring substantial value in the business to intended heirs while retaining a predetermined cash flow.

Example

Will Grant is 60 years old and owns a business through an S corporation of which he owns 100%. The business is worth $2 million and earns $200,000 per year, which he distributes to himself on an annual basis.

If the business were to appreciate 20% a year for seven years, it would be worth approximately $8 million at the end of that seven-year period. Estate taxes could exceed $4 million. Will decides to transfer a 49% interest in the S corporation to a seven-year GRAT and retain a 10% annuity during that period. If the minority interest in the corporation is subject to a 30% minority interest discount (so that the value of the assets contributed to the GRAT is equal to approximately $700,000), the value of the retained interest will be equal to $351,750, thereby resulting in a gift equal to $700,000 minus $351,750, or $348,250. At the end of the seven-year GRAT term, he will have saved almost $2,000,000 in estate and gift taxes and created a succession plan.

Thus, a donor can retain control of the stock through his status as the trustee of the GRAT, retain as well the entire $200,000 income per year, and still transfer a substantial portion of the company to his children for a minimum of estate and gift tax consequences.

Qualified Annuity Interests/Fixed Term

In drafting the trust instrument for a GRAT, it is imperative that the trust provide for the retention of a "qualified annuity interest," which consists of the right to receive fixed amounts payable no less frequently than annually. Furthermore, the trust instrument must provide for a fixed term of years. As previously stated, if the grantor predeceases that fixed term, all of the trust corpus will be pulled back into the grantor's estate for estate and gift tax purposes. However, if the client is survived by a spouse, there will generally be no tax due, provided that the grantor's will provides a disposition for such interest which qualifies for the marital deduction.

Minimizing the Mortality Risk of a GRAT/GRUT

As stated earlier, if the grantor dies during the annuity term of a GRAT or a GRUT, the entire amount of the GRAT/GRUT property will be included in the gross estate of the grantor. Thus, despite the fact that the grantor may have paid a gift tax or used all or a portion of the lifetime exemption equivalent at the time the GRAT is created, all of the GRAT benefits will generally be lost.

In order to minimize this risk, the grantor could consider entering into an agreement with the beneficiaries of the GRAT (let's assume the grantor's children) by which the children would contract with the grantor to purchase the contingent reversionary interest (i.e., the assets of the GRAT if the grantor were to predecease the trust term) for fair market value. The grantor's estate would pay the children the value of any amount that it would receive from the GRAT if the grantor were to die before the GRAT term ends. Furthermore, all of the annuity payments that would have been paid to the grantor for the remaining term of the GRAT following the grantor's death would be a portion of the GRAT proceeds payable to the children under their agreement.

As provided in the Internal Revenue Code, an estate is entitled to a deduction for all claims against the estate, provided that such claims were contracted for with adequate and fair consideration in money or money's worth. Thus, the estate of the grantor may then be entitled to an estate tax deduction equal to the amount that the estate is required to pay the children upon the death of the grantor.

Under the terms of such an agreement, the children would agree to pay the grantor (the parent) a purchase price equal to the actuarial value of the grantor's contingent reversionary interest, as determined under the applicable IRS tables. Thus, the purchase price of the contingent reversion interest would, by definition, be equal to full and adequate consideration supporting the estate's deduction for such payment to the children at the time of the parent/grantor's death.

Although this structure is premised on the fact that the value of the grantor's contingent reversionary interest would not exceed the benefits to the children, such value can be substantial and the children would need the requisite funds to pay for the grantor's reversionary interest. This payment could be made as a lump sum at the time of the agreement, or, in the alternative, the children could agree to pay for the grantor's interest through a promissory note entered into on an arm's-length basis. However, the children would still need the requisite funds to make the debt service payments on the note. In order to make such funds available, the parent could make gifts to the children. In this regard, it is imperative that such gifts not be made at the same time that the debt service payments are due. The gifts should not correspond to the debt service payments either in timing or in amount. Furthermore, if the grantor survives the GRAT term, the children's acquisition cost of the contingent reversionary interest would be lost.

Detailed in Figure 22.1 is an example of a GRAT created by Maxwell Fobee. Maxwell transferred a $1 million property into a GRAT and retained an annuity of 10% per year for the shorter of life expectancy or 10 years. By retaining such a large annuity, the gift has been zeroed out; thus no gift tax will be due. If the asset appreciates at the rate of 10% through life expectancy (2023) and remains in the grantor's estate, the estate tax savings will be $4,881,091.

In general, such interest payments made payable to the parent/grantor will

Grantor Retained Annuity Trust
for Maxwell Fobee

Transfer Date 09/06/2000	AFR 7.59%
Based on Shorter of Life or Term (10 yrs)	Discount Pct .00%

Property Value	$1,000,000
Times Payment Percentage	.10000
Equals Annual Payment	$100,000
Times Annuity Factor	6.3583
Equals Value of Return to Donor	$635,830
Remainder (Gift)	364,170
Remainder (Gift) per IRS	364,170
Gift Tax	$0
Value of Property at Death in 2023 (without Transfer)	$9,238,881
Retained Payments + Gift of Remainder	364,170
Property Transferred Tax Free	8,874,711
Times Marginal Estate Tax Rate	.55
Projected Estate Tax Savings	**$4,881,091**

Figure 22.1 Grantor Retained Annuity Trust for Maxwell Fobee

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be taxed to such parent as interest income. Thus, the grantor might consider establishing a trust for the benefit of the children that could be used to pay the interest on the promissory note. Such trust would be irrevocable and thus treated as the children's trust for estate tax purposes but could be structured as a grantor trust for income tax purposes. Interest on the note could then be paid by the trust to the parent/grantor and would be treated, for income tax purposes, as being made by the grantor/parent to himself or herself and thus not treated as interest received for tax purposes as there are no tax consequences that stem from the payment and/or receipt of income to/from oneself. The grantor/parent could then avoid income tax upon the receipt of the interest income from the trust.

The IRS could argue that the consideration paid for the grantor's reversionary interest would be equal to full and adequate consideration only if the price paid for such reversionary interest equaled not only the reversionary interest but the entire value of the assets in the GRAT (thus creating a gift aspect to the transaction). However, because the grantor's interest is only that of a contingent reversionary interest subject to valuation according to IRS tables, it appears that such an argument would not withstand the scrutiny of the courts. Accordingly, since the law is not yet established as to children buying the contingent reversionary interest, one must be willing to undertake a battle if the IRS challenges the transaction.

The estate tax cost associated with such a technique for reducing the mortality risk of a GRAT or GRUT is simply that the moneys paid to the parent for establishing such a guarantee would theoretically increase the size of the grantor/parent's estate. However, this cost may be more than offset by several factors, including the removal of the GRAT assets from the estate of the grantor should he or she predecease the GRAT term, as well as the ability of the parties to consider increasing the term of the GRAT without fear that the entire transaction would be lost if the grantor/parent were to die before the end of the GRAT term.

Sale of the GRAT Remainder Interest to a Dynasty Trust

As stated earlier, another general limitation to utilizing a GRAT as an effective estate planning tool is the fact that the grantor cannot allocate the generation-skipping transfer tax exemption (GST exemption) to the remainder beneficiaries at the time of the establishment of the GRAT. Under the applicable provisions of the Internal Revenue Code, because the value of the assets transferred to the GRAT would be included in the grantor's estate if he or she did not survive the GRAT term, the GST exemption rules would not apply, thus negating the benefit of a GRAT if the grantor wished to include grandchildren (and possibly great-grandchildren) in the pool of beneficiaries.

In such situations, the parties should consider the establishment of a GRAT with children as the remaindermen-beneficiaries who may then subsequently enter into an agreement to sell their remainder interest to a GST-exempt dynasty trust. This would allow for distributions to be made to successive generations without additional transfer taxes. In order to avoid the tax treatment of such a transfer as a gift by the children to their children for tax purposes, the purchase price must be the fair market value of the remainder interest as determined under the applicable tables of the Internal Revenue Code. Furthermore, because the grantor retains a contingent reversionary interest in the GRAT, the value of such reversion must be reflected in the value of the remainder interest. Accordingly, the price paid by the dynasty trust must take into account the value of the reversionary interest.

GRAT Planning After the Enactment of the 2001 Tax Act

With the uncertainty created by the passage of the Economic Growth and Tax Relief Reconciliation Act of 2001, there is a question whether the use of a GRAT is still warranted. In response to this question we would respond yes—in certain situations. First, until December 2008, there are not a lot of statutory changes that will affect tax planning for larger estates except for the phased-in increases to the exemption equivalent and a slight reduction in estate tax rates. Accordingly, GRATs still make sense in many situations. This is particularly true in light of the uncertainty that repeal will ever take place (and if it does, whether it will stay in place).

The same concept behind a GRAT of leveraging gifts to remove the assets from one's estate and allowing them to grow outside that estate still makes sense. In this regard, the new Tax Act actually increases the lifetime gift tax exemption to $1 million, thus providing the ability to remove even more assets from one's estate utilizing the GRAT or GRUT structure. However, in this environment of estate tax uncertainty, it is generally not recommended that one utilize a GRAT structure that goes beyond the current date of repeal (January 1, 2010), nor is it recommended that one make gifts valued in excess of $1 million thus incurring a gift tax at the time of the transfer to the GRAT. However, it still makes sense to enter into one or more short-term GRATs, including perhaps a tiered GRAT structure (of, say, three-, five-, and seven-year durations). Simply because Congress has acted (which, as we all know, Congress does at least once a year, and certainly every time there is an election) does not mean that you should stop planning. It is hard to imagine under what economic environment (let alone political environment) Congress will allow repeal to stand, or allow us to even get that far. In the meantime, you should consider planning with flexibility in case there is repeal, but also continue planning on a tax-advantaged basis in the more likely event that estate tax repeal never comes to fruition.

Conclusion

The use of a GRAT or GRUT as part of the estate plan for a sophisticated, high-net-worth individual or family can create significant estate and gift tax savings. However, the use of such a vehicle requires close analysis of the facts and a thorough understanding of the law underlying such techniques. Accordingly, it is imperative that an individual contemplating the use of this type of structure work closely with one's professional advisers to ensure that the benefits that are offered by such a structure are realized.

CHAPTER 23

Intentionally Defective Grantor Trusts

Introduction

So your annual exclusions are fully utilized, your exemption equivalents have been exhausted by both you and your spouse, and yet, having valued your assets, there is still substantial estate tax exposure. Moreover, you still own assets that are producing a steady stream of income and will continue to grow in value. For one who is desirous of continuing the gift-giving process to family members but is out of annual exclusions and exemption equivalents, the intentionally defective grantor trust (IDGT) may be the answer.

The concept behind an IDGT is simple. You create a trust for the benefit of your children and sell certain assets to the trust in return for a long-term installment note. By creating the IDGT and selling assets to the trust, you have, in essence, converted an appreciating asset (the asset sold) into an asset with a fixed value (the promissory note) while simultaneously retaining the right to receive a consistent stream of income from the long-term installment note for the purpose of securing your retirement income. Inasmuch as an intentionally defective grantor trust is not structured as a gift transaction, a gift tax return does not have to be filed, nor will any gift tax be owed so long as the asset is sold to the IDGT for fair market value.

The Major Benefit of an IDGT

The estate tax benefit of transferring the appreciating asset out of your estate may be incentive enough to enter into an IDGT, but what really makes an IDGT intriguing is its ability to take advantage of the discrepancies between the income tax and the estate tax provisions found in the Internal Revenue Code. Incredible as it may seem, the grantor trust rules in the income tax provisions do not coincide with those in the estate tax provisions. Thus, it is possible to design a trust that is treated as a grantor trust for income tax purposes but is not treated as a grantor trust for estate tax purposes.

If the IDGT is designed correctly, it will be treated as a grantor trust for income tax purposes and any transactions between the grantor (the creator of the IDGT) and the IDGT will be ignored under the income tax provisions of the Internal Revenue Code. However, the same trust agreement can be drafted so that the IDGT will not be included in the grantor's estate for estate tax purposes.

The typical structure of an IDGT involves the grantor's sale of appreciated assets to the IDGT in return for a long-term installment obligation issued by the IDGT. The obligation may provide for payment of interest only, with a balloon payment at the end of the note term. Because the IDGT will be ignored for income tax purposes, the sale of the assets by the grantor to the IDGT will not be subject to capital gains tax, and the interest payable on the note will not be subject to income tax. Instead, any income earned by the IDGT on the assets held by the trust, although creating value for the IDGT, will be treated as earned by the grantor. As a result, the income taxes paid by the grantor on the income earned by the IDGT will, in fact, have the effect of further reducing the size of the grantor's estate while creating additional value outside the grantor's estate.

However, during the period the grantor owns the installment note (which is fixed in value), the assets inside the IDGT continue to appreciate outside the grantor's estate. Thus, if the grantor has assets which are expected to appreciate greatly in future years, he or she can sell them to the IDGT in consideration for a long-term note. The grantor then sets the interest rate on the note at the lowest rate allowable under the tax law while still avoiding any gift tax consequences.

The value included in the grantor's estate will equal only the face value of the note, and the assets inside the trust will pass to the heirs according to the terms of the trust agreement. If the assets placed in the IDGT grow faster than the interest charged on the installment sale note, the net appreciation of the assets (in excess of the note payments back to the grantor) will take place outside the grantor's estate, thus reducing the estate taxes that would have been due on the appreciating assets if they had remained in the grantor's estate.

Implementation of an IDGT

In order to implement this structure, the grantor must first create the IDGT which, as described, will be structured as a grantor trust under the income tax provisions and as a nongrantor trust for estate tax purposes. Next, the grantor must capitalize the IDGT with sufficient assets to reflect its independent status. It is generally advised that the IDGT have amounts independent of those to be purchased from the grantor in an amount equal to approximately 10% to 20% of the value of the installment note. This can be accomplished by having the grantor prefund the trust with cash or other assets. The transfer of this small percentage of the eventual value of the IDGT will be treated as a gift to the grantor's beneficiaries for gift tax purposes.

Following the capitalization of the IDGT, the trustee of the IDGT then enters into the sales agreement for the purchase of the grantor's assets at their fair market value in consideration for an installment obligation. (A third party can guarantee the obligation to help support the legitimacy of the transaction.) In order for the transaction to withstand IRS scrutiny, it is imperative that the assets acquired by the IDGT are accurately valued for purposes of the sale. Otherwise, the transaction could inadvertently create a part sale, part gift situation.

For example, the owner of a closely held business with a fair market value of $1 million can create an IDGT designed as a grantor trust for income tax purposes but not for estate tax purposes. Assume the grantor's business has developed a product that will result in the substantial appreciation of the company and its stock in the future. The grantor creates the IDGT and sells the company stock to the IDGT for $1 million, taking back a $1 million installment note with a nine-year term and an interest rate equal to the minimum rate required under the tax law (in this case the mid-term applicable federal rate).

If the business is unable to generate sufficient income to pay the interest on the note, the grantor can fund the IDGT with sufficient cash to pay the interest on the note. Any amounts contributed to the trust by the grantor will, however, be treated for gift tax purposes as additional gifts by the grantor to the beneficiaries of the trust.

Nine years later, the product produced by the company has been a great success and the value of the company has appreciated from $1 million to $5 million, generating more than enough cash flow to enable the trust to pay back the $1 million principal on the note, and resulting in $4 million passing outside the grantor's estate.

In the alternative, the trust could contribute $1 million of the company's stock (now only 20% of the company's value) back to the grantor as repayment on the note. In either case, at least $4 million of the $5 million company is now owned by the IDGT for estate tax purposes and is excluded from the grantor's gross estate upon death. All transactions between the grantor and the IDGT remain exempt from income tax because of the trust's status as a grantor trust for income tax purposes.

In addition, if the IDGT pays back the grantor at the end of the note term with appreciated property (20% of the company stock in this example), the basis in the appreciated property now owned by the grantor will be stepped up at the time of death, resulting in additional income tax savings by the grantor's beneficiaries if and when they go to sell the stock following the grantor's death. In the alternative, the grantor may consider repurchasing the entire $5 million business, thus transferring cash to the trust and taking back the appreciated company stock, and perhaps creating a new IDGT (or equivalent vehicle) for the company at a later date. The cash inside the trust can then be used to acquire a diversified portfolio for the benefit of the trust beneficiaries (i.e., the grantor's heirs), which will continue to grow and appreciate outside the grantor's estate.

Drafting the IDGT Trust Agreement

It is imperative that the trust instrument creating the IDGT be carefully drafted to take advantage of this lack of symmetry in the Internal Revenue Code. Certain provisions must be put in the trust instrument so that it will be treated as a grantor trust for income tax purposes but not for estate tax purposes. These provisions may include giving the trustee (who can be the grantor's spouse) the discretion to apportion income and principal from the trust among the grantor's heirs without limiting the power by reference to an ascertainable standard. (For this purpose, limiting standards include restricting expenditures for specified purposes such as the beneficiary's health or education.) Because the grantor does not retain any powers that he or she can personally exercise, the transfer is deemed complete and the trust is not includable in the grantor's estate.

Another provision that can be placed in the trust agreement to take advantage of this lack of symmetry in the grantor trust rules is to provide the grantor or a nonadverse party (not a creditor or governmental agency) with the power (in a nonfiduciary capacity) to acquire trust property by substituting other property of an equivalent value. A number of other methods exist for creating this discrepancy between the income tax grantor trust rules and the estate tax grantor trust rules, but these two methods have proven to be the easiest to facilitate.

IDGT versus GRAT

Advantages of an IDGT over a GRAT

There are certain advantages inherent in an IDGT when considering the use of an IDGT as opposed to a GRAT. Unlike the grantor of a GRAT, the grantor of an IDGT need not survive the term of the trust in order to reduce the taxable estate. If the grantor predeceases the term of the installment note received in consideration for the sale of assets to the trust, the value of the note is simply included in the estate for estate tax purposes (rather than the value of the assets sold to the IDGT). If this is a concern, the note can be designed as a self-canceling installment note (SCIN), which would be automatically canceled at the time of the grantor's death (see Chapter 25, "Self-Canceling Installment Notes and Private Annuities"). Be aware, however, that if it is determined that a SCIN is appropriate, either the interest on or the principal of the note must be increased in order for the note to qualify as a SCIN.

Second, as discussed in Chapter 22, "Grantor Retained Annuity Trusts and Grantor Retained Unitrusts," the interest rate set by statute for a GRAT must be equal to at least 120% of the mid-term applicable federal rate (AFR). However, if an installment note with a three- to nine-year term were taken back by the grantor upon the sale of assets to an IDGT, the interest on such a note need equal only 100% of the mid-term AFR to avoid the imputed interest rules under the estate and gift tax regulations.

Furthermore, unlike a GRAT, an IDGT is perfect for generation-skipping tax planning. The IDGT can be generation-skipping transfer (GST) tax exempt, and the sale of assets in exchange for a note should not require an allocation of the grantor's GST $1 million exemption (see Chapter 8, "Generation-Skipping Transfer Tax") because it's a sale, not a gift.

Finally, with an IDGT, a grantor's spouse can be a beneficiary without adverse estate tax consequences, whereas if the grantor's spouse were the beneficiary under the terms of a GRAT instrument, the entire corpus of the trust would continue to be included in the grantor's estate, even after the termination of the trust.

Disadvantages of an IDGT versus a GRAT

However, as you might suppose, there are certain disadvantages in choosing an IDGT over a GRAT which should also be carefully analyzed before choosing one method over the other. One risk of using an IDGT over a GRAT is the potential for undervaluing the assets being acquired by the IDGT in consideration for the installment note. If the assets sold to an IDGT are not accurately valued, the IRS could argue that, at the time of the sale, the grantor actually created a part gift/part sale, resulting in gift tax consequences that might include penalties, interest, and assessed gift tax costs.

Furthermore, the IDGT is premised upon the assumption that the assets sold to the trust will appreciate in value over time. Accordingly, if the value of the assets placed in the IDGT actually decreases to an amount less than the face amount of the note taken back by the grantor, the IDGT would have insufficient funds to pay off the debt. Furthermore, the value of the note retained in the estate of the grantor could, in effect, be larger than the assets transferred out of the estate at the time of the sale of the assets to the IDGT.

Conclusion

The IDGT is an exceptional estate planning tool for one who has exhausted the traditional gifting techniques and still has tremendous estate tax exposure coupled with assets that are continuing to appreciate. Because the use of an IDGT as an estate planning tool involves the sale, rather than gift, of one or more assets to the trust, a gift tax return need not be filed. The utilization of an IDGT still serves as an effective tool for transferring assets to your loved ones at a fixed price in return for a steady stream of income to the seller (the senior family member), thus continuing to provide an effective estate and business planning tool for wealthy taxpayers. However, it is imperative that an individual looking to use such a vehicle work closely with his or her tax advisers and that the trust be closely monitored to ensure that it is respected both at the time of its inception and during the period in which it remains in existence. Unless one is relying on the remote chance the estate tax repeal will become a reality, an IDGT remains a staple as an estate and business succession tool.

CHAPTER 24

Split Dollar Life Insurance

Introduction

Jean-Claude Pierre, fickle and temperamental, is the truly gifted chef at the famed restaurant La Crêpe. La Crêpe has developed a reputation throughout the city as the chic French restaurant with a six-month waiting list and home to the rich and famous. Prior to Jean-Claude becoming the head chef at La Crêpe, the restaurant was rarely full on weekends. In fact, the owners, Rudy "Flash" Ruden and Vito Molito, were thinking about closing the doors and absorbing their losses. But after they hired Jean-Claude and the customers began enjoying the finest crêpes east of the Mississippi, the restaurant began to blossom.

One Saturday night, Rudy and Vito were in the back room counting their money when Jean-Claude burst in demanding that he share in the profits and become a one-third partner in La Crêpe, Inc. Jean-Claude continued to lament that earning $65,000 per year with no upside in the restaurant was simply not enough, and unless they were to make him a partner, he was going to hang up his spatula and retire. After Jean-Claude left, Rudy and Vito knew this was a real problem. They did not want Jean-Claude to be their partner, but knew if he left they could be finished. They called their attorney, who told them that they might want to consider offering Jean-Claude a split dollar benefit package, which is a form of golden handcuffs.

The lawyer went on to summarize a split dollar plan by informing Rudy and

Vito that the plan would not grant Jean-Claude an ownership interest in the business but would provide him with what he really wanted—more money. In fact, the lawyer continued, the owners could provide Jean Claude with potentially hundreds of thousands of dollars that could grow tax free inside a life insurance policy and vest over a 5- to 10-year period. If Jean-Claude were to quit, he would not fully vest in the compensation program. Therefore, it would behoove Jean-Claude to remain as the head chef so that he could continue to vest in the split dollar plan. The best part, explained the lawyer, was that any monies laid out by La Crêpe, Inc., would ultimately be repaid to the owners upon death or termination, so whatever their out-of-pocket costs will be (insurance premiums), they would ultimately be reimbursed.

The owners explained this compensation package to Jean-Claude, while simultaneously advising him that if he were to be an owner he would have to sign personally on the lease as well as on the credit lines, and be responsible for the burdensome administration involved in running the business. Jean-Claude was quick to accept the split dollar compensation plan and was eager to finalize the arrangement, which he realized was a form of retirement planning that could help him retire comfortably as well as providing his heirs with a much-needed life insurance policy, without any significant sacrifices.

The term "split dollar life insurance" is often erroneously thought of as referring to a type of life insurance policy, but it is actually a method of financing the acquisition of life insurance rather than a type of policy. Specifically, the term "split dollar" refers to the manner in which the respective parties pay for the premiums on the life insurance. Historically, split dollar life insurance has been designed to provide key employees an added perk as part of their compensation packages.

In a typical split dollar arrangement, the premiums are split between the employer and employee. Generally, it is advisable when setting up such a split dollar plan that the parties utilize some type of permanent life insurance that can build cash value, such as individual and survivorship policies, whole-life, universal life, and variable life insurance. Note that term life insurance provides no buildup of cash value inside the policy and therefore is not advisable if the goal of the split dollar plan is to provide both retirement planning and estate planning benefits.

The Split Dollar Financing Arrangement

A typical split dollar financing arrangement involves the acquisition of a life insurance policy by the employer for one or more of its key employees. There are many variations. However, in a typical arrangement, the employer pays the larger share of premiums—that is, the costs associated with building up the cash value inside the insurance policy. The employee pays for or reports as compensation (if this amount is paid for by the employer) the cost of the pure life insurance (i.e., typically, the cost of acquiring an annually renewable term life insurance policy).

The cost of the pure life insurance is generally referred to as the "annual economic benefit cost." You may also have seen or heard this cost referred to as the "P.S. 58" cost for an individual life insurance policy, or the "P.S. 38" cost for a survivorship (or joint life) policy. The term "P.S. 58" referred to the government table used to determine how much the employee is required to report for income tax purposes as the pure cost of the death benefit associated with the life insurance policy acquired in the split dollar arrangement. The P.S. 58/P.S. 38 rates were based on mortality tables originally published in 1946. In 2001, the IRS published Notice 2001-10, in which it announced that the IRS will no longer accept the P.S. 58/P.S. 38 rates as a proper measure of the value of current life insurance protection for federal tax purposes. Instead, a new table has been created entitled "Table 2001," which the IRS will accept for taxable year 2001 and beyond. (See Table 24.1.) In the alternative, taxpayers may use an insurer's actual one-year term insurance rates, provided that such one-year term rates are actually charged as premiums to policyholders through

TABLE 24.1 Table 2001: Interim Table of One-Year Term Premiums for $1,000 of Life Insurance Protection

Attained Age	Section 79 Extended and Interpolated Annual Rates	Attained Age	Section 79 Extended and Interpolated Annual Rates	Attained Age	Section 79 Extended and Interpolated Annual Rates
0	$0.70	35	$0.99	70	$20.62
1	$0.41	36	$1.01	71	$22.72
2	$0.27	37	$1.04	72	$25.07
3	$0.19	38	$1.06	73	$27.57
4	$0.13	39	$1.07	74	$30.18
5	$0.13	40	$1.10	75	$33.05
6	$0.14	41	$1.13	76	$36.33
7	$0.15	42	$1.20	77	$40.17
8	$0.16	43	$1.29	78	$44.33
9	$0.16	44	$1.40	79	$49.23

(Continued)

TABLE 24.1 *(Continued)*

Attained Age	Section 79 Extended and Interpolated Annual Rates	Attained Age	Section 79 Extended and Interpolated Annual Rates	Attained Age	Section 79 Extended and Interpolated Annual Rates
10	$0.16	45	$1.53	80	$54.56
11	$0.19	46	$1.67	81	$60.51
12	$0.24	47	$1.83	82	$66.74
13	$0.28	48	$1.98	83	$73.07
14	$0.33	49	$2.13	94	$80.35
15	$0.38	50	$2.30	85	$88.76
16	$0.52	51	$2.52	86	$99.16
17	$0.57	52	$2.81	87	$110.40
18	$0.59	53	$3.20	88	$121.85
19	$0.61	54	$3.65	89	$133.40
20	$0.62	55	$4.15	90	$144.30
21	$0.62	56	$4.68	91	$155.80
22	$0.64	57	$5.20	92	$168.75
23	$0.66	58	$5.66	93	$186.44
24	$0.68	59	$6.06	94	$206.70
25	$0.71	60	$6.51	95	$228.35
26	$0.73	61	$7.11	96	$250.01
27	$0.76	62	$7.96	97	$265.09
28	$0.80	63	$9.08	98	$270.11
29	$0.83	64	$10.41	99	$281.05
30	$0.87	65	$11.90		
31	$0.90	66	$13.51		
32	$0.93	67	$15.20		
33	$0.96	68	$16.92		
34	$0.98	69	$18.70		

the insurance company's standard distribution channels. In the case of a typical term life insurance policy, the Table 2001 cost generally increases as the employee ages.

Thus, a careful analysis must be undertaken to ensure that the split dollar arrangement does not become cost prohibitive to the employee as he or she ages.

Under a typical split dollar arrangement, the employer receives a portion of the death benefit upon the death of the employee. That portion is equal to either (1) the amount of the premiums that the employer has paid out or (2) the cash value of the insurance as of the date of the termination of the policy. The employee's estate (or insurance trust if one has been established for holding the insurance policy) will receive the death benefit over and above the amount payable to the employer.

Benefits of a Split Dollar Arrangement

Why would an employer want to enter into a split dollar financing arrangement with certain employees? Because such an arrangement serves as an inducement for the employees to remain in the employer's business. In fact, offering an employee a split dollar insurance package is often done in lieu of providing the employee an interest in the company itself.

The employee will be interested in such an arrangement because, depending on age and health, he or she may pay only the costs as provided pursuant to Table 2001 as if the policy was term insurance and yet receive all the benefits associated with a permanent life insurance policy. These benefits include the right to cash value buildup inside the policy, even possibly the right to borrow against such cash value inside the policy on a tax-free basis.

A split dollar arrangement is most cost efficient when the employee is relatively young so that the cost of the annual term life insurance premium is low. Many times, as part of the split dollar plan, the employer will pay the employee a bonus equal to the amount of the employee's contributions, grossed up to include the anticipated tax on the bonus, so that the entire arrangement serves as a pure economic benefit to the employee.

A split dollar agreement may provide for a termination of the plan (generally referred to as a "rollout") at a specified time. At that time, the employee repays the employer for the amount of the employer-paid premiums and receives the insurance policy outright. A rollout is generally structured so that the transfer of the policy takes place only after the insurance has been fully funded. Thus, the employee will not have to pay any future premiums on the insurance policy.

Furthermore, the split dollar arrangement should be designed to ensure that there is sufficient cash value in the insurance policy to provide the necessary funds to repay the employer for the premium outlay. The employer and employee recognize that the timing of the rollout will coincide with retirement or just ensure the employee doesn't quit before vesting in the plan.

A variation of the rollout is the "crawl-out." Under a crawl-out arrangement, the employee continues paying the annual economic cost to the employer, even after the premiums have been offset by dividends, until the employee's cumulative contributions have fully repaid the employer for its outlay. When the employer is repaid, the plan terminates, and the employee has full ownership of the insurance policy. The reason for choosing a crawl-out over a rollout is that under the terms of a crawl-out the employee, rather than the policy, funds the repayment of the employer's premium outlay.

Tax Consequences

Prior to the publication of Notice 2001-10, the tax consequences of a split dollar arrangement were relatively straightforward. In general, the employee was treated as having received taxable compensation income each year equal to the annual economic benefit (the annual term cost of P.S. 58 cost), reduced by any amount paid on the annual premiums by the employee. However, in Notice 2001-10 the IRS provided that the employee must account for his or her rights in the cash surrender value of the life insurance policy in an equity split dollar arrangement.

Historically, in a typical split dollar arrangement, the employer would pay the employee an annual bonus equal to the P.S. 58 cost, plus an additional amount calculated to take care of the income tax on the entire amount paid by the employer. In this manner, the employee would receive the entire benefit without any offsetting tax detriment. The employee would then continue to work for at least the term of the premium pay-in period and upon retirement would own the life insurance policy with a substantial cash value. The employee could then borrow against the cash value of the life insurance policy, thus providing tax-free retirement funds, if necessary, or simply retain the full face value amount of the insurance policy for the benefit of his or her family.

Under the terms of Notice 2001-10, the IRS in essence has taken the position that this tax characterization of a split dollar arrangement fails to identify properly the employee's entire benefit upon receipt of the insurance policy. The IRS asserts that if the employee is receiving the economic benefit reflected in the cash value within the insurance policy, the employee must include such amount in his or her gross income at the time such benefit is substantially vested. Under the terms of the Notice, the employee would generally be required to take such cash value increases into gross income each year as compensation income, thus substantially reducing the tax benefits of the split dollar arrangement.

In the alternative, the IRS has specifically sanctioned the treatment of the split dollar arrangement, for tax purposes, as a loan pursuant to which the employer is treated as lending the employee the premium amounts on the insurance policy on an annual basis. The IRS then provides that, if the parties respect this loan arrangement, the employee need include only the imputed interest on the loan in his or her income each year, which rate of interest is determined pursuant to the applicable federal rates posted by the IRS each month. Then, at the time the employee gains unrestricted ownership of the life insurance policy, either he or she must reimburse the employer for the loans made to pay the premiums or, in the alternative, the employer can release the employee from the obligation to repay the premiums at that time. If the employee is released of the obligation to repay the amounts lent, he or she would incur gross income to the extent of such release, which the employer can bonus to the employee in order to pay the tax.

Ownership of the Life Insurance Through an Irrevocable Life Insurance Trust

After conferring with an estate planner and insurance professional, the employee may decide to create an irrevocable life insurance trust to own the policy. Thus, for estate tax purposes, the death benefit is removed from the taxable estate. However, when a life insurance trust owns the policy, the employee is treated, for estate and gift tax purposes, as having made a gift to the trust each year much in the same way you would if you had established an insurance trust for an insurance policy you would have otherwise acquired for yourself.

As in a typical irrevocable life insurance trust, the measure of the gift will be the annual premiums paid by the grantor (here, the employee). However, by placing the policy in trust, one can exclude from the estate the entire amount of the insurance proceeds and thereby reduce estate taxes at the time of the insured's death. Furthermore, because the measure of the gift (the annual economic benefit) is not the full premium on the permanent insurance policy, the insurance proceeds can be excluded from the estate with little, or no, gift tax cost. However, the ability to borrow against cash value may be prohibited by the trust document.

Different Types of Split Dollar Arrangements

There are several different methods for structuring the repayment of premiums to the employer through a split dollar arrangement. The two most common are the collateral assignment method and the endorsement method.

Collateral Assignment Method

In a collateral-assignment split-dollar arrangement, the employee (or an irrevocable trust established for holding the policy) applies for and owns the policy. A portion of the value of the policy is collaterally assigned, or secured, by the employee or his or her trust to the employer. This is done to ensure that the employer is repaid the premiums it has advanced during the pay-in period, since the employer does not own any part of the policy itself.

When the split dollar arrangement is terminated (at the time of the death of the employee or when the policy is cashed out or rolled out), the employer is reimbursed for the amount of the premiums that it has paid. Both the trustee of the insurance trust and the insurance company must honor the collateral assignment, which has a similar effect as a mortgage on real property. Before the death benefit is paid, or upon the employee's retirement or termination, the collateral assignment must be satisfied.

Endorsement Method

Under the endorsement method, the employer serves as the purchaser and owner of the insurance policy. A separate agreement is entered into between the two parties, spelling out the employee's rights to the insurance policy. The employer names itself as beneficiary of an amount equal to the cash value of the policy at the time of the insured's death and, by endorsement, provides that the insured employee or his or her assignee (such as an insurance trust) has the right to name and change the beneficiary of the portion of the proceeds in excess of the cash value.

Loans from the Cash Value in the Life Insurance Policy

Although the split dollar method is not free from tax cost, a properly designed split dollar arrangement can provide a substantial benefit, both by way of tax-free loans (which can be treated as additional retirement benefits), as well as by way of substantial insurance proceeds available upon the death of the employee to his or her heirs.

For example, assume a 20-year split dollar arrangement was created for Jean-Claude Pierre. Upon retirement, the policy would have a cash value of $1.6 million. Accordingly, for each of the next 17 years (his actuarial life expectancy) he could borrow, tax free, $65,000 (17 × $65,000 = $1,105,000) to invest and help secure his comfortable retirement while still having enough money to repay the crawl-out obligation to La Crêpe, Inc. subject to the amount due to La Crêpe, Inc. If he died, the collateral assignment would simply be repaid out of the death benefit. Note, however, that these types of payout models are based on insurance company projections, and the amount of money projected is not guaranteed; the reality will depend on the actual investment performance inside the insurance policy itself. Additionally, a split dollar agreement will govern the structure of the obligations between the parties.

Private Split Dollar

Private split dollar plans, sometimes referred to as family split dollar, consist of an insurance financing arrangement between a family member or a trust and the insured. Unlike employer-employee split dollar arrangements, it does not involve an employer. Rather, a third-party family member or trust assumes the role of the employer and provides the lion's share of the funds that go to pay the premiums for the life insurance on the insured. In a typical arrangement, private split dollar is set up on a collateral assignment plan where the owner of the policy (generally an insurance trust) owns the policy and collaterally assigns all of the cash value to the payer of the premiums, typically individuals related to the insured, such as the insured's spouse and children.

The primary benefit of a private split dollar financing arrangement is to provide for funding of insurance premiums without the limitation of the annual exclusion, while simultaneously providing the insured's family access to the cash value of the insurance policy. As discussed in Chapter 7, "Irrevocable Life Insurance Trusts," traditional insurance trust planning requires that annual gifts equal to the premium payment be made to the insurance trust, with the general goal of avoiding gift taxes through the use of Crummey withdrawal powers and the $11,000 annual exclusion gifts. As a result, with the increasing size of premium payments on large insurance policies or where the insured is getting on in years, the likelihood is greater that the premiums gifted to the insurance trust will result in taxable gifts.

In a private split dollar arrangement, a family member (usually the spouse) can pay a large portion of the premium payments (reducing the size of the premiums required to be gifted to and paid by the insurance trust), thus reducing or eliminating any taxable gifts. The trust is required to pay only the annual economic benefit cost, which is usually a small fraction of the entire premium to be paid and thus needs much less in the way of funding to pay its share of the premiums.

In two recent private letter rulings, this type of arrangement was ruled upon favorably by the Internal Revenue Service. In Private Letter Ruling 9636033 the insured's spouse entered into a split dollar arrangement with a newly created irrevocable life insurance trust pursuant to which the trust and the spouse each paid a portion of the premiums for a policy on the taxpayer's life. The IRS ruled that the payments would not result in a taxable gift to the trust by either the taxpayer or the spouse, and the death benefit payable to the trust would not be includable in the taxpayer's gross estate.

In the ruling, the trust purchased the policy and entered into a collateral-assignment split-dollar arrangement with the spouse by which the trust paid an amount of payments equal to the lesser of the P.S. 58 costs or the one-year term cost, with the spouse paying the balance of the premiums out of her separate funds. The taxpayer retained no powers over the trust, and neither the spouse nor the taxpayer served as a trustee of the insurance trust. As in the case with traditional split dollar, the spouse (in the role as the employer) was entitled to an amount equal to the greater of the premiums she paid or the net cash value of the policy according to the collateral assignment agreement at the time of her husband's death.

In the ruling, the IRS determined that there was no inclusion of the death benefits in the estate of the insured taxpayer because the insured had retained no incidents of ownership in the policy and no powers over the trust. Be aware, however, that under the ruling if the spouse (or whichever family member is advancing the funds to pay this portion of the premium) is entitled to receive only the premiums he or she paid, there is a risk that the equity buildup would constitute an additional gift to the trust or other family members.

In putting this type of arrangement in place, it is imperative that the will of the insured's spouse (or whichever family member is making the payments to the trust for the premiums) must provide that the spouse or such family member's ownership of the cash value of the insured's policy not be given to the insured or to a testamentary trust of which the insured is either a trustee or a beneficiary so that the insured will not be deemed to have any incidents of ownership in the policy.

In Private Letter Ruling 9745019, the IRS addressed similar issues with regard to a second-to-die life insurance policy placed in an irrevocable life insurance trust that was created by a husband and wife with one of their children as trustee. In that ruling, the husband and wife paid the premium above the P.S. 38 cost of insurance and then entered into a collateral assignment agreement with the trust by which they would receive out of the death benefit their interest in the split dollar arrangement. The IRS ruled that other than their rights under the collateral assignment arrangement, the husband and wife retained no incidents of ownership in the policy so that the death benefits were not includable in either the husband's or the wife's estate.

Conclusion

A split dollar arrangement can be a cost-efficient technique for bringing together an employer and an employee and providing the employee with an additional incentive to remain loyal to the employer. This type of an arrangement can serve as an efficient and effective compensation tool for an employee and may vest for over several years and create a form of golden handcuffs. Furthermore, it can also be effectively utilized in a family situation to address the need to fund increasing premium payments without the limitation of the annual exclusion.

The key is to analyze carefully the costs associated with providing these benefits with the desired result as to all participants. As in all cases, in order to provide a complete and accurate analysis of the situation, one should always utilize the services of a sophisticated insurance professional, as well as legal and accounting advisers.

CHAPTER 25

Self-Canceling Installment Notes and Private Annuities

Introduction

As discussed in previous chapters, the lifetime transfer of appreciating assets to family members provides many benefits for avoiding or reducing onerous estate tax liabilities. However, gifting such property has a number of drawbacks. These drawbacks include the potential gift tax consequences for gifts over and above the lifetime gift exemption as well as the reduction in the income of the donor following such gifts, which may come at a time when such income may become necessary to sustain a donor's standard of living.

Selling Assets as an Estate Planning Tool

As an alternative, senior family members may wish to consider selling assets to junior family members rather than giving them away. This is generally accomplished through the use of a sale in consideration for a long-term installment note. Such a technique can provide income for the senior family members while still accomplishing the goal of transferring the future appreciation in the assets sold to the family members.

However, such a method has the effect of leaving the long-term note in the estate of the senior family member throughout its term, which can produce unwanted estate tax consequences should the seller die prior to the end of the note term. Two possible solutions are the self-canceling installment note (SCIN) and the private annuity. Both techniques provide income to the senior family member selling the assets during his or her lifetime, but with each technique the debt automatically terminates upon the death of the seller. Obviously, both the SCIN and the private annuity are most effective in situations where the senior family member is not expected to survive his or her actuarial life expectancy, has exhausted the exemption equivalent (and is not willing to pay gift tax), and is reasonably certain the asset will appreciate. In addition, the junior family members must have sufficient cash flow to fund the annual payments on the SCIN or private annuity.

Self-Canceling Installment Note

A SCIN is designed like any other installment obligation, but with a twist. As with other types of installment notes, a SCIN provides for an agreed-upon number of fixed payments at a specific interest rate over a set period of time. However, unlike the terms of other installment notes, a SCIN possesses a unique feature: It automatically cancels upon the death of the note holder.

This self-canceling feature creates a number of gift and estate tax issues that could technically recharacterize the installment sale as part sale, part gift. However, these issues can be successfully addressed by requiring the purchasers to pay a premium for the self-canceling feature. The premium can take the form of either an increased amount paid for the asset (with a corresponding increase in the note principal) or an increase in the interest rate payable to the seller on the installment note. Although the IRS has not provided any definitive regulations as to what this premium should be, the following factors must be taken into consideration:

- Seller's age at the time the note is executed.
- Probability of receipt of each note payment each year.
- Applicable federal rate.

As the probability of receipt goes down, the SCIN premium goes up. Generally, however, SCIN premiums tend to range between 2% and 4% over and above the Code Section 7520 rate, which is equal to 120% of the mid-term (three to nine years) applicable federal rate. This premium can be costly. Therefore, if the senior family member still runs marathons, eats gingerroot, and drives in the right lane, the junior family member might want to reconsider utilizing a SCIN.

A properly structured SCIN will be treated as an installment obligation under the applicable provisions of the Internal Revenue Code. Therefore, the senior family member will be subject to tax on the interest paid by the junior family member(s), as well as the capital gains tax on any gain recognized upon the sale of the appreciated assets over the term of the note. Assuming the selling family member is a cash-basis taxpayer, this gain will be picked up each time a principal payment is made and will equal the amount of principal payment received each year minus an allocable portion of the seller's basis in the assets sold.

To address this issue, the SCIN can also be structured so that the installment note provides for interest-only payments for a specific length of time, followed by a balloon payment of principal at or toward the end of the note term. Under such an arrangement, the seller would receive interest over the life of the note and pay tax on the interest as received. The junior family member/purchaser could deduct the interest paid on the SCIN, subject to the typical limitations on interest deductibility for investment acquisitions.

For estate tax purposes, the assets being sold by the senior family member will be excluded from his or her estate at the time of death if death occurs before the note's satisfaction, provided that the sale is treated as complete at the time the parties enter into the SCIN. In this regard, it is imperative that the premium paid for the self-cancellation feature be fair and reasonable; otherwise, the obligation could be treated as a transfer in which the transferor has retained a life interest. The result could be that the entire value of the assets sold would be included in the estate of the selling senior family member at the time of death.

To avoid this situation, both sides of the transaction must respect the sale of the assets and the term of the SCIN. Accordingly, the senior family member is prohibited from the use or enjoyment of the assets sold and should not in any way limit the buyer's rights over the property, although the assets can be used as collateral for the note. Under the installment obligation provisions of the Internal Revenue Code, the assets should not be resold by the junior family member for at least two years. To do so generally accelerates the tax consequences to the senior family member, requiring him or her to report the gain on the sale of the assets in the year subsequent to the sale by the junior family member.

As mentioned earlier, if the seller does not survive the term of the SCIN, the balance of the note is not included in the decedent's estate and the amount that the junior family member is required to pay for the assets is reduced by the number of installments left on the note. Furthermore, if the seller does die before the note matures, the junior family member has no recognition of gain since the buyer is deemed to have paid fully for the assets at the note's inception. However, the amount of gain on the sale of property that goes unrealized by the seller due to his or her premature death will still be treated as income in respect of the decedent, taxable to the seller's estate.

For example, a senior family member age 65 sells stock in the family business with a basis of $100,000 and a fair market value of $1 million to his son in exchange for a 10-year interest-only SCIN. If the father dies prior to the end of the term of the note, the son is not required to make any further payments on the note and owns the stock free and clear. Furthermore, the son receives a basis in the assets purchased equal to the fair market value at the time of the sale regardless of whether the father survives the term of the SCIN. However, the $900,000 gain ($1 million fair market value minus $100,000 basis) that would have been recognized by the father in year 10 (upon the due date of the balloon payment on the SCIN) will be treated as a capital gain in the decedent's estate.

Detailed in Figure 25.1 is an example of the potential estate tax benefits of Maxwell Fobee, who sold a commercial property valued at $2 million, to his children over a 15-year SCIN. If the asset remains in his estate until his actuarial date of death and appreciates at the rate of 10% per year, the SCIN approach may save over $10 million in estate taxes.

Private Annuities

A private annuity is similar to a SCIN in that (1) both the private annuity and the SCIN can provide the senior family member a stream of income in return for selling assets to the junior family members and (2) when the seller/senior family member dies the SCIN terminates and the annuity ends, neither being includable in the senior family member's estate for estate tax purposes.

However, there exist certain major distinctions between the two techniques. The primary nontax difference between the private annuity and the SCIN is that, in general, an annuity, by definition, lasts for the remaining term of a seller's life, regardless of how long he or she lives. Furthermore, under the terms of a private annuity, unlike a SCIN, the assets sold cannot be used as collateral for the annuity.

For income tax purposes, with both a SCIN and a private annuity, the

SCIN INT for
Maxwell Fobee

Transfer Date 09/21/2000	AFR 7.6%
SCIN Term 15 Years	Current Interest 6.3%
Interest Premium Is 3.3842%	Discount Pct .00%

Total Value of Property Sold	$2,000,000
Annual Note Payment	258,227
Value of Property at Death in 2023 (without Sale)	$22,109,487
Value of Payment Retained	3,336,667
Property Transferred Tax Free	18,772,820
Times Marginal Estate Tax Rate	.55
Tentative Estate Tax Savings	$10,325,051
Less Income Tax at Death	$0
Projected Estate Tax Savings	**$10,325,051**

Figure 25.1 SCIN for Maxwell Fobee

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seller is treated as if the property were sold for a long-term obligation. However, if the seller receives a private annuity in consideration for the sale of assets, the term of the obligation is equal to his or her life expectancy, and the annual payment made to the annuitant (the seller) consists of three parts:

1. The return of basis portion.
2. The capital gain portion.
3. The ordinary income portion (which is generally equivalent to the interest portion on a SCIN).

Under the terms of a private annuity, the interest rate on the interest portion of the annuity must equal or exceed the statutory rate of 120% of the federal mid-term rate for the month the annuity contract is entered into. Unlike interest payments on a SCIN, the interest portion of an annuity is not deductible by the obligor. A private annuity is not treated as an installment sale under the Internal Revenue Code, and payments made to the annuitant by the purchasers are not deductible as interest. Furthermore, the obligor's basis in the assets remains open and is adjusted with each annual payment. Accordingly, each portion of an annuity payment characterized as either gain to or recovery of basis for the annuitant increases the obligor's basis in the property. If the annuitant dies before the full recovery of basis (based on the annuitant's life expectancy), the transaction will be deemed complete. However, unlike the SCIN, the obligor of a private annuity will recognize a gain in the year of the death of the annuitant to the extent of the unpaid obligation.

A properly structured private annuity will result in the removal of the assets sold from the estate of the senior family member/seller in accordance with the terms of the private annuity. No taxable gift will occur with a properly structured private annuity sale as long as the present value of the annuity is equal to or in excess of the fair market value of the property. However, as in the case of a SCIN, if the private annuity is not properly structured or not for fair market value, it may result in the sale being treated as part sale, part gift. Even worse, if the private annuity were treated as a retention of a life estate by the annuitant, it could cause the entire property to be included in the annuitant's taxable estate.

Be aware that IRS regulations prohibit the use of actuarial tables in establishing the value of the annuity if the annuitant suffers from a terminal disease and has at least a 50% chance of dying within one year. Also, as noted earlier, a private annuity will result in adverse gift and/or estate tax consequences if the assets sold are used as collateral for the annuity or if the annuity payments are in any way restricted by the income produced by the assets being sold. In addition, if the obligor is not personally liable on the annuity contract or if the facts and circumstances demonstrate that it was never feasible to make the annuity payments, the assets may be pulled back into the seller's estate for estate tax purposes.

Finally, unlike the finite term of a SCIN, a private annuity generally runs for the entire life of the annuitant. Thus, the seller can outlive his or her life expectancy, necessitating continuing annuity payments. To address this issue, the parties should consider drafting the private annuity to provide that payments will terminate on whichever occurs first: death of the annuitant or a set term of years. This issue should be carefully laid out for the parties so that the senior family member understands that the private annuity could run out prior to his or her death.

Detailed in Figure 25.2 is an example of a single private annuity created for Maxwell Fobee (age 61) based on a $2 million sale in exchange for an annual payment of $215,364 for Maxwell's life expectancy of 25 years. Note a projected estate tax savings of over $10 million.

Single Private Annuity for Maxwell Fobee	
Transfer Date 09/21/2000	AFR 7.6%
Age at Transfer 61	Discount Pct .00%
Value of Property	$2,000,000
Divided by Annuity Factor	9.286600
Equals Annual Annuity Payment	215,364
Value of Property at Death in 2023 (without Sale)	$22,109,487
Value of Payment Retained	3,406,016
Property Transferred Tax Free	18,703,471
Times Marginal Estate Tax Rate	.55
Projected Estate Tax Savings	**$10,286,909**

Figure 25.2 Single Private Annuity for Maxwell Fobee

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Conclusion

The use of SCINs and/or private annuities to augment an estate plan may provide additional estate and gift tax benefits. Since neither of these techniques involves gifts, a gift tax return need not be filed nor a gift tax paid. These tools should be carefully considered in situations where one or more senior family members do not anticipate living as long as the generally accepted life expectancy rates. However, such instruments cannot be used when individuals know that they will die within a short period of time. Such situations are treated as shams and ignored by the Internal Revenue Service.

Since both SCINs and private annuities are based only in part on estate tax savings, the utilization of these tools must make sense on a transactional basis independent of estate taxation in the unlikely event of estate tax repeal. As both techniques lock in a sales price, provide an income stream to the senior family member, step up basis to the buyer, and provide a mechanism for business succession planning, they remain viable business succession strategies. However, as in the case with all sophisticated estate planning tools, family members must look to their team of advisers before deciding whether such structures are right for their particular facts and circumstances.