Estate Planning *Strategies*

A NEWSLETTER HIGHLIGHTING CURRENT ESTATE PLANNING CONCEPTS

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BUSINESS OWNERSHIP SUCCESSION PLANNING

Family businesses are facing an unprecedented wave of change in management and ownership over the next decade as a multitude of successful baby-boomer entrepreneurs transition to retirement and pass their businesses on to generations X and Y. However, these business owners face a formidable challenge in making this transition a success, as historically only thirty percent of family businesses survive to the second generation and only twelve percent survive to the third generation.

A successful transition requires both planning in advance and updating the transition plan as circumstances change. Taxes and family dynamics are two significant considerations in the planning process. The following discussion focuses primarily on tax issues. However, if the business will stay in the family, the impact of the business succession planning on the relationships among the family members also must be considered.

One of the first decisions to be made in business ownership succession planning is to whom the senior generation desires to pass the ownership of the business. Will the business stay in the family or will it be sold? If the business will stay in the family, which family members will become owners and what will their involvement in the company be? If the business will be sold, to whom will it be sold?

Transition to Family Members

Once the critical decision regarding the successor business owner is made, the next step is to determine how to implement the transition. If the ownership will stay in the family, gift and estate tax planning plays a central role in structuring a successful transition. Lifetime gifts of interests in the company may be made outright or in trust by using the $12,000 per year per donee annual gift tax exclusion ($24,000 in the case of a married couple) or the $1,000,000 lifetime gift tax exclusion ($2,000,000 in the case of a married couple), or by making taxable gifts.

Lifetime gifts may be leveraged with discounts for minority interests and for lack of marketability, supported by appropriate appraisals. Gifts may be further leveraged through the use of grantor retained annuity trusts (GRAT). A GRAT is a trust in which the grantor retains an annuity interest for a term of years and transfers the remainder interest to his or her desired beneficiaries at the end of the term. The gift to the beneficiaries is the present value of the remainder interest. If a business owner transfers shares or units in the business to a GRAT and the business outperforms the assumed interest rate used to compute the present value of the remainder interest, the value actually transferred to the beneficiaries at the end of the GRAT term is greater than the amount subject to gift tax, which effectively leverages the gift of the remainder interest. This strategy is particularly effective for a business experiencing increasing profitability.

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While lifetime gifting is an important aspect of planning for the transition of business ownership to family members, due to the caps on the gift tax exclusions, affecting a complete transfer of ownership during life without paying gift tax typically is not feasible. Thus, estate tax planning, with associated consideration of continuing ownership and control of the business, is necessary.

In the case of a married U.S. citizen couple, estate taxes may be deferred until the death of the surviving spouse through the use of the unlimited marital deduction. Interests in the business may pass to the surviving spouse in trust. If the spouse is not involved in the business, consideration may be given to appointing a person familiar with the operation of the business as trustee of the trust. In addition, where the combined ownership of the business by both spouses constitutes a majority interest, a qualified terminable interest marital trust (QTIP) may be used to secure minority interest valuation discounts for estate tax purposes at the demise of the surviving spouse. Shares or units passing from the first deceased spouse to a QTIP trust will be included in the taxable estate of the surviving spouse, but the shares or units will not be aggregated with any shares or units the surviving spouse owns individually for valuation purposes.

> EXAMPLE: Husband and wife each own forty percent of FamCo and son owns twenty percent. Appraised minority interests in FamCo are subject to a thirty percent minority interest valuation discount. Husband's estate plan provides for the transfer of his forty percent interest in FamCo to a QTIP marital trust for wife at his demise. At wife's subsequent demise, both the forty percent of FamCo held by the QTIP trust and her forty percent of FamCo will be included in wife's taxable estate, but they will be valued separately, with a thirty percent minority interest discount applied to each interest.

Even with effective planning, estate tax at the death of the surviving spouse is highly likely. Fortunately, where the family business constitutes a significant portion of the surviving spouse's estate, full payment of the estate tax may be deferred for almost fifteen years, with interest on the deferred payment computed at a favorable rate. Specifically, if the family business constitutes at least thirty-five percent of the surviving spouse's adjusted gross estate, estate tax on the non-business assets is due nine months after the date of death, but estate tax on the business is deferred with only interest on the deferred tax due for the next five years, and with interest and one-tenth of the deferred tax due in the sixth through the fourteenth years. The tax deferral and reduced interest rate can greatly reduce the financial pressure of the lack of liquidity in estates with substantial family business interests.

Shareholder restriction and buy-sell agreements as well as life insurance are important aspects of business ownership succession planning, particularly where continued family ownership of the business is desired. Any significant lifetime transfer of shares or units should be accompanied by appropriate limitations on further transfers. For an owner with limited non-business assets, consideration should be given to shareholder and member purchase obligations and to company redemption obligations in the event of the death or disability of the owner to provide needed liquidity to the owner's estate and family. Oftentimes funding such purchase obligations requires life insurance. Establishing a valuation methodology for any such purchase or redemption obligation typically requires careful consideration. Restrictive agreements generally will only be respected for gift and estate tax valuation purposes to the extent that they constitute bona fide business arrangements with terms comparable to those entered into in arm's-length transactions.

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If the business owner expects to continue to own the business throughout his lifetime, careful consideration should be given to the selection of the individuals and institutions to act as agent under his durable property power of attorney, as executor of his estate and as trustee of his trust, as well as to the powers granted to these fiduciaries. The agent under the business owner's durable power of attorney and the executor of his estate will typically have the authority to exercise the rights of the owner with respect to any interests in the business that the owner holds in his individual name if the owner becomes disabled and at the owner's death. The trustee of the owner's trust typically will have the authority to act with respect to business interests transferred to the trust.

Consideration should be given to including detailed provisions in the will and trust regarding authority to retain and continue the operation of the business, particularly if the business will constitute a significant part of the estate or trust. In many situations a business advisor is appointed under the will or trust, and in those circumstances the respective responsibilities of the business advisor and the executor and/or trustee should be addressed. If the business advisor, executor or trustee also has an interest in the business, the subject of conflicts of interest should be considered. Additionally, if the business is an S corporation and ownership of the business will pass to trusts under the business owner's estate plan, the trusts under the estate plan must be structured to qualify as permissible S corporation shareholders.

Transition to Third Parties

In some situations, the decision will be made *not* to transition the family business to the next generation. In that case, the income tax consequences of the exit strategy, rather than the gift, estate and generation-skipping transfer tax consequences, will be of greatest concern from a tax planning perspective.

For a business owner who is charitably inclined and who plans in advance, a charitable remainder trust may be used to defer the income tax burden on the sale of a business interest. Under this planning strategy, the business owner transfers part or all of his or her shares or units to a charitable remainder trust (CRT). The business owner and his or her spouse are the lifetime beneficiaries of the trust and a charity or charities are the remainder beneficiary/ies. The owner may deduct the value of the gift of the remainder interest from his income tax in the year of the gift, subject to certain limitations and carryovers. If the shares or units of the business held by the CRT are later sold, there will be no immediate income tax to the CRT as the CRT is exempt from tax. However, a portion of the lifetime distributions to the business owner and/or spouse will be subject to tax. This planning strategy will not work unless the CRT is established independent of the sale of the business.

> EXAMPLE: Wife owns BusCo. Her only child is a professional who is not interested in operating BusCo. Wife transfers her interest in BusCo to a CRT that provides for an eight percent annual payout to wife and husband for their lifetimes. She obtains a charitable income tax deduction in connection with her transfer to the CRT. Two years later CRT sells its shares in BusCo. Gain on the sale of BusCo is not taxed to the CRT at the time of the sale. A portion of the gain will flow through to wife and husband over the years in which the eight percent payout from the CRT exceeds the ordinary non-exempt income of the CRT.

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Another non-family sale strategy is a sale to an employee stock ownership plan (ESOP) for the employees of the company. In very brief summary of this complex planning strategy, if a business owner or executor sells qualified securities in a C corporation (not an S corporation) to an ESOP and then purchases qualified securities in a domestic operating company with the proceeds of the sale, he may defer the long-term capital gain on the sale. The business owner or estate recognizes gain on the sale only to the extent that the amount realized on the sale of the securities to the ESOP exceeds the cost of the replacement property. The business owner or estate generally recognizes gain when the replacement property is disposed of. However, transfers of replacement property by gift or at death do not trigger recognition of gain. In addition, under present law the replacement property will receive a basis step-up at the demise of the owner to its then fair market value.

Successful business ownership transition requires careful consideration to numerous aspects of the transition by a team of advisors, including legal counsel. If you have questions regarding business ownership transition alternatives, we encourage you to contact your Chapman and Cutler Trusts and Estates attorney.