BUSINESS SUCCESSION PLANNING

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1. BUSINESS SUCCESSION PLANNING

1.1 Generally: If you have an interest in a business, either the law or you will determine how that business interest will pass to someone else when there is a "triggering event", such as when you decide to sell, become incapacitated, decide to retire or withdraw from the business, become insolvent, or die.

(a) The business may be a sole proprietorship, or it may be an interest in a formally organized business entity, such as:

(1) a sole proprietorship;

(2) a partnership interest in a general partnership, limited partnership, or limited-liability partnership;

(3) a membership interest in a limited-liability company; or

(4) stock in a corporation.

(b) "Business succession planning" refers to the planning for changing ownership of business interests. There is no one document that does effective business succession planning. It requires a coordinate of several documents to do proper planning, including:

(1) Each owner's will and/or living trust;

(2) The documents governing the company (such as articles of incorporation, articles of organization, bylaws, operating agreement, partnership agreement, etc.); and

(3) "buy-sell" agreements.

1.2 Default Provisions: To the extent the documents that are prepared are silent or conflicting, state law will fill in the gaps, sometimes only after involvement of the courts. It is to everyone holding an interest in a business to agree, in advance, what rights each owner has and what limitations should apply with respect to transferring business interests.

2. PLANNING OBJECTIVES

2.1 Questions: The first step to any planning is to identify the goal. There are a number of questions you will be asked in order to do the proper planning.

(a) Do you want the business to remain in the family or to pass to key employees?

(b) Do you want to sell the business and then invest the net proceeds?

(c) What are your cash flow needs and income-tax objectives?

(d) Is the federal estate tax a concern? Do you intend to qualify for the extended payout of taxes under Internal Revenue Code (IRC) § 6166, a special-use valuation under IRC § 2032A, or a deduction for a family-owned business under IRC § 2057? What would be different if the estate tax were repealed or if the exclusion were increased so the estate tax did not apply to you?

2.2 Basic Tools: There are a number of tools that can be used to plan for business succession.

(a) *Wills and Trusts:* If the primary objective is succession planning at death, a will or a revocable trust is an essential tool to specify who will get what interests and on what terms and conditions. If the federal estate tax is an issue, a critical element will be the provisions that direct how the estate tax is to be paid for. If non-business assets are insufficient to pay the estate tax on the business interests, business interests would have to be sold or encumbered (borrowed against) in order to provide cash for tax payments. IRC § 6166 permits those who inherit a business that has a value of at least 35% of the estate's total value to take up to 15 years to pay the estate tax, which essentially results in a long-term promissory note payable to the IRS by those who inherit the business.

(b) *Buy-Sell Agreements:* One of the most popular planning tools for business interests is the "buy-sell agreement". It may be called a "shareholders agreement", an "owners agreement", or a "redemption agreement", and sometimes the terms of a buy-sell agreement are incorporated into partnership agreements, limited-liability company operating agreements, bylaws, or other agreements. "Buy-sell Agreements" are discussed more fully in section 3 of this memo.

(c) *Gift-Giving*: The most common way to shift business interests to family members is to make gifts. Gifts of interests in a family business are usually entitled to valuation discounts because of lack of voting control and the lack of marketability. By making lifetime gifts, it is often possible to reduce a person's interest to a minority share (especially for married couples owning equal interest), entitling the estate to a valuation discount for estate-tax purposes.

(1) Gifts of business interests are attractive because the value of such interests for gift-tax purposes is less than the pro-rata value. In other

words, a 5% business interest has a fair-market value of less than 5% of the business' assets because of certain valuation "discounts" that apply, including a discount for lack of voting control and a discount for lack of marketability.

(2) A qualified business appraiser is required to determine the extent of the discount applicable in each situation.

(3) This gift-giving is often done using one or more forms of irrevocable trusts as the recipients of the gifts.

(4) This is more fully discussed in a separate memo entitled "Estate Reduction Using Business Interests", which you should ask for if you do not already have it.

(d) *Estate Freezing*. Buy selling your business for an installment note, the value of what will be included in your estate is "frozen". In fact, as the note is paid off, the value that is included in your estate may diminish (depending on how you spend the amount received as payments). If you are given a private annuity or a self-canceling installment note, it is possible to exclude all value from your taxable estate at your death.

(e) *Charitable Trusts*. Some times charitable trusts can be used to carry out a sale of a business with reduced tax consequences. The business is given to a charitable trust, and the charitable trust is free to sell the business without generating a capital gain tax. This is often done in conjunction with an irrevocable life insurance trust, as is described in the memo entitled "Using a Charitable Trust and an Irrevocable Life Insurance Trust", which you can request.

3. BUY-SELL AGREEMENTS

3.1 Issues in Buy-Sell Agreements: Buy-sell agreements are as varied as are the businesses that they relate to. There are a number of issues that need to be addressed in a properly designed buy-sell agreement.

(a) *Triggering Event*. A sale and purchase may be triggered by a number of events, such as an owner's incapacity, death, insolvency, desire to withdraw, or receipt of an offer to purchase from an outsider. The buy-sell agreement may not cover all situations, and it may cover different situations with different provisions, but the more "triggering events" that are addressed in the agreement, the less likely there will be a controversy.

(b) *Obligation vs. Right to Sell or Purchase.* There is a different between an obligation and a right.

(1) A buy-sell agreement might provide that, upon the occurrence of a triggering event, an owner (the "selling owner") must sell and the company or the other owners (the "purchaser") must purchase the selling owner's interest. This is a mandatory buy-sell agreement, and it is favored when estate-tax valuations are important.

(2) On the other hand, it is possible to draft an agreement that says that only one of the parties has an election to sell or purchase and that the other party has to abide by that election. For example, it is possible that if an owner wants to sell shares to a third party, he is required to sell to the other owners or to the company for the same price and on the same terms, but only if the other owners and/or the company elect to purchase. This is a "right of first refusal", and it is common to have this apply to transfers for value, but it normally does not apply to a disposition at death under a will or trust.

(c) *Redemption vs. Cross-Purchase.* The agreement might require the company to purchase the selling owner's interest (a "redemption") or it might require the other owners to make the purchase (a "cross-purchase"). Many agreements use both provisions, giving the other owners the right to purchase if they chose to exercise it and requiring the company to purchase if (or to the extent that) the owners do not do so. The cross-purchase arrangement will increase the other owners' income-tax basis on their holdings whereas a redemption arrangement will not.

3.2 Insurance: Where a triggering event can be covered by insurance, such as disability or death, a buy-sell agreement should describe whether such insurance is mandatory or optional, how it is to be paid for, and how the proceeds are to be applied.

(a) Insurance is often made more affordable if the premiums are paid out of the company's cash flow, usually under a "split-dollar" arrangement that meets IRS requirements.

(b) The use of irrevocable insurance trusts or an "insurance partnership" may help reduce estate-tax inclusion for the owners of the insurance.

(c) If insurance is not provided for or is inadequate, the agreement should provide for an alternative method of payment, usually in the form of a long-term note that will allow the purchaser(s) to make affordable payments.

3.3 Price: Probably the most important factor in a buy-sell agreement is the method for setting the purchase price.

(a) It is common to merely pick an "agreed upon price", but that can become out-of-date quickly, and an out-of-date price is usually an unfair price for at least one of the parties.

(b) Probably the best method is to provide for a qualified appraiser to determine the price, but some businesses can be valued using a formula based on asset values, net income during the past few years, and other factors.

(c) Where the federal estate tax is an issue, it is important that the buy-sell agreement be designed so that the Internal Revenue Service (IRS) will accept the price under the agreement as the value of the business interest for estate tax purposes.

(1) An owner's successors would not want to have to accept $250,000 as a purchase price under a legally binding agreement only to find out the IRS has determined that the business interest is really worth $1.5 million. In that case, the taxes due would exceed the purchase price.

(2) In order for a buy-sell agreement to be binding on the IRS, the agreement must comply with IRC § 2703(b), which requires that the agreement be a "bona fide business arrangement", "not a device to transfer such property to members of the decedent's family for less than full and adequate consideration in money or money's worth", and, it must have terms that "are comparable to similar arrangements entered into by persons in an arms' length transaction."

3.4 Advisors: In crafting a customized business-succession plan and buy-sell agreement, the business owner's accountant should play a key role in evaluating the tax implications and cash-flow needs of the business and its owners, and a business-appraiser or other expert in business valuations will be essential in helping to determine the appropriate method for fixing the price of the business and any applicable valuation discount factors.

4. SALE TO GRANTOR TRUST

4.1 Background: Frequently, a business owner would like to transfer a business, or an interest in a business, to his or her family, but a lifetime transfer by gift or a distribution at death under a will or trust would trigger an unaffordable gift or estate tax. A sale to the family might be acceptable, but the purchase price may be unaffordable to the family members, and frequently the capital gain tax that is triggered is very significant. The solution may include the gift and sale of nonvoting interests in a business to a trust that is a grantor trust for income tax purposes but excluded from the estate of the grantor for estate tax purposes.

4.2 "Sale to Grantor Trust": This technique is referred to as the "sale to a grantor trust" or a "sale to a defective[1] grantor trust". For clients who want to transfer a business to their children or other beneficiaries, it is possible to transfer part as a gift and part as a sale. This works best with a business that is organized as a "pass-through" entity for federal income tax purposes, such as an S corporation, a partnership, or a limited-liability company.

(a) *Step One: Create nonvoting interests.* The company should be reorganized with a nonvoting class of ownership. For limited partnerships and limited-liability companies, this step may be unnecessary because state law provides that transferees are not substitute partners or members, and they automatically have no vote.

(b) *Step Two: Create a "grantor trust".* Establish a trust that is considered a "grantor trust" for federal income tax purposes but that will not be included in the settlor's estate for federal estate tax purposes. A "grantor trust" is a trust over which the settlor (grantor) has some powers that cause the trust to be ignored for income tax purposes. The settlor pays all income taxes on the income of the trust, even if the trust is either accumulated in the trust or distributed to other beneficiaries.

(c) *Step Three: Give cash or business interests to the trust.* The trust should be funded with cash or other assets so that he has some of its own assets. A rule of thumb is to contribute 10% of the value of the business that is going to be purchased. So, if your business has a net worth of $1 million, make a gift of $100,000 to the trust. If the gift involves business interests, because to have a business appraiser establish a fair market value of the gift using a valuation discount based on lack of voting control and lack of marketability.

(d) *Step Four: Sell the nonvoting business interest to the trust.* To establish the purchase price, be sure to use a qualified business appraiser establish a fair market value of the interest being sold based on a valuation discount based on lack of voting control and lack of marketability. The trust will provide a promissory note to the settlor, and the trustee will make payments on the note until the note is paid off. [The note should not be forgiven or ignored. The IRS will ignore the note and treat the entire sale as a gift unless the note is paid under reasonable terms.]

(e) *Result:* For businesses with a cash flow that is sufficient to pay its operating expenses and to pay income to the owner (the trust), this technique will allow

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[1] In the past, an irrevocable trust that was deemed a grantor trust for income tax purposes was considered "defective". For that reason, some commentators refer to an irrevocable grantor trust as a "defective grantor trust" ("DGT") or an "intentionally defective grantor trust" ("IDGT"), but I dislike that term because there is nothing "defective" about it. It is simply a grantor trust that was intentionally designed to be so.

the next generation (or whoever the beneficiaries are) to receive part of the business at a discounted gift-tax valuation and to purchase the balance of the gift at the same discounted price.

5. CONCLUSION

For a smooth transition of a business or of business interests, it is important to plan ahead. It is particularly important to consider the transition in a number of scenarios, including receipt of an offer, disability, retirement, insolvency, or death. For business interests that will or may pass at death, a will or revocable trust is a good starting point, but there are a number of tools that are important to consider, depending on the business owner's objectives. Effective business-succession planning is not easily done without taking into consideration the unique circumstances that apply, and it is important to involve an accountant and a business-valuation expert in crafting the right plan.

[END: Version of March 22, 2008]

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