Legacy by Design, LLC

Estate Planning for Business Owners

Succession Planning

Farmers, Ranchers, & Family Business Owners

Kevin Spafford, Certified Financial Planner™
(530) 671-2100 • Kevin@RyanWealth.com

WEALTH MANAGER AND SUCCESSION PLANNING SPECIALIST

Kevin Spafford, CERTIFIED FINANCIAL PLANNER™, helps farmers, ranchers, and family business owners plan for succession. Kevin's planning process is designed to enhance the family's financial security, create a smooth ownership transition, and mitigate the tax consequences.

As the architect of the *Farm Journal Legacy Project*, Kevin effected consumer behavior and improved the way family business owners engage in the succession planning process. Through the *Project*, Kevin has:

- Published more than 300 columns in Agriculture's leading magazines.
- Facilitated workshops for thousands of farm and ranch families across the U.S.
- Written multiple workbooks and created several client planning tools.
- Produced weekly eNewsletters for subscribers across the country.
- And, hosted 5 seasons of '*Leave a Legacy*' TV.

Prior to the publication of his book *Legacy by Design: Succession Planning for Agribusiness Owners* (Marketplace Books®) in 2006, Kevin founded Legacy by Design, a succession and financial planning firm dedicated exclusively to serving the succession planning needs of farmers, ranchers, and agribusiness owners.

Among a series of professional designations and licenses, Kevin is a CERTIFIED FINANCIAL PLANNER™ and he's earned a Bachelor of Science in Agricultural Management with a concentration in Business, from California Polytechnic State University, San Luis Obispo, CA.

On a personal note, Kevin enjoys flying, fishing, hunting, and camping. He and his wife, Anne-Marie, have been married 37 years. They are proud parents of their son Drew and his wife Dana, and their daughter Sara and her husband Michael. In July of 2018 they welcomed their first grandchild. They live in Durham CA.

Kevin@RyanWealth.com
463 Century Park Drive
Yuba City CA
(530) 671-2100

RYAN WEALTH MANAGEMENT

LEGACY BY DESIGN, LLC

ESTATE PLANNING FOR BUSINESS OWNERS

The goal of most business succession plans is to provide for an orderly transition of management and ownership when the owner retires. Unfortunately, this goal may be defeated if the owner dies before retirement. Thus, the business succession plan should also adopt estate planning measures that minimize the impact an owner's premature death has on the transition of business ownership and management.

Many planners believe that transferring ownership of the business during the owner's lifetime is the optimal strategy. For various reasons, however, many owners maintain some level of ownership until they die. In this case, the estate plan must also complete the succession plan. Therefore, planning for the ownership interest held at death often must achieve multiple goals, including minimizing estate tax, providing income for a surviving spouse, and eventually, transferring ownership in the business to the intended successors.

THE ROLE OF ESTATE PLANNING IN A SUCCESSION PLAN

Many practitioners equate estate planning for closely held business owners with succession planning. Although there is a degree of overlap between the two practice areas, their goals are different. Succession planning strives to develop a plan that will provide for an orderly transition of the ownership and management of the business at the owner's retirement, disability or premature death. Accordingly, it focuses on transferring ownership to family members, co-owners, key employees, or third parties and identifying capable successors to manage the business. Estate planning addresses transferring wealth to heirs, providing for survivors, and minimizing estate, gift and generation-skipping transfer taxes.

A business owner's estate plan should be an integral component of the owner's overall succession planning strategy. Typically, the estate plan will complement the owner's succession plan in order to minimize the risk that they will produce conflicting results in the event the owner dies prior to retirement. Estate planning techniques (e.g., gifting, family limited partnerships, etc.) may also be used to facilitate the transfer of ownership to family members. In addition, the estate plan sometimes serves as the succession plan in those situations where the owner has no intention of retiring.

Owner's Exit Strategy Is a Lifetime Sale of the Business

When the goal of the succession plan is to provide for a transfer of ownership and management during the owner's lifetime, there is always the possibility that the owner will die unexpectedly before the transfer occurs. Thus, it is important to ensure that the owner's estate plan complements the succession plan. Otherwise, the effort spent designing and implementing the lifetime transfer strategy may be lost.

A buy-sell agreement is an effective tool to help ensure that an owner's estate plan does not adversely affect the business succession plan. It identifies the purchaser (i.e., the ownership successor) and specifies the events that will trigger the sale of the owner's interest in the business. In the case of a lifetime sale, the agreement generally grants the intended successor a right to purchase the business interest at a specified price when the owner retires. Assuming the owner lives to his or her retirement age, the intended successor has the opportunity to acquire the ownership interest. If the successor does not exercise the right to purchase the interest, the owner is often free to sell to a third party.

Even when the owner wants to transfer ownership during his lifetime (e.g., at retirement) there is always the possibility he will die prior to the intended transfer date. Thus, the buy-sell agreement should also provide for a sale at the owner's death. Otherwise, the business will become part of the owner's estate and will pass in accordance with the owner's will, which may not produce the desired result.

In the case of a sale occurring at the owner's death, the buy-sell agreement often obligates the intended successor to acquire the owner's interest. The successor typically uses life insurance proceeds that are received as a result of the owner's death to purchase the owner's interest in the business. As a result, the owner's estate receives cash and perhaps other consideration from the sale of the business. This consideration becomes part of the decedent's estate and is distributed in accordance with the decedent's will. Thus, it can be used to provide for a surviving spouse or make equitable transfers to the children.

In addition to ensuring that the business is transferred to the intended successor when the owner dies prematurely, a buy-sell agreement that obligates the successor to purchase the business at the owner's death provides other benefits. First, the proceeds from the sale provide liquidity that can be used to pay expenses and distributions to the owner's heirs. In addition, the buy-sell agreement can be used to establish the estate tax value of the business.

Owner's Exit Strategy Is to Sell the Business at Death

Many owners have no intention of selling their business before they die. Even though they will not sell the business during their lifetime, these owners should still execute a buy-sell agreement with the intended ownership successor in order to establish a ready market for the business interest at their death. This helps ensure that the owner's estate will have adequate liquidity to pay taxes, expenses and other distributions. In addition, executing the buy-sell agreement allows the owner to negotiate the sale price when he or she has maximum leverage and avoids the risk of a "fire sale" at the owner's death.

In the case of a buy-sell agreement that provides for the sale of the business at the owner's death, the purchase obligation can usually be funded with proceeds from life insurance on the owner. In these cases, the planner's role is twofold. First, the planner should ensure that there is adequate insurance to fund the obligation. This is accomplished by estimating the value of the interest to be purchased and comparing it to existing insurance coverage available for the purchase. Any shortfall can be made up with the acquisition of additional coverage or a structured purchase on terms.

The planner should also verify that the insurance used to fund the purchase obligation will be excluded from the owner's gross estate for federal estate tax purposes. When the owner's children will acquire the business, the owner often assists through gifts in the purchase of life insurance used to fund the acquisition. In these cases, an irrevocable life insurance trust can be used to keep the proceeds out of the owner's estate. If the business will be acquired by existing co-owners, it may be beneficial to use a partnership to acquire the life insurance policies.

In addition to ensuring that the buy-sell agreement and adequate funding are in place, the planner needs to design an estate plan for the disposition of the proceeds realized on the sale (as well as the owner's other assets). In the case of a married owner, his or her first priority is usually to provide for the surviving spouse. Typically this is accomplished using transfers that qualify for the unlimited marital deduction in order to defer estate taxes until the death of the surviving spouse. However, it is important to ensure that the owner's applicable exclusion amount is fully utilized.

There are also numerous estate planning techniques that can be used to remove a portion of the business from the owner's estate (e.g., a gifting program) or reduce its value (e.g., valuation discounts). These techniques may also be appropriate depending on the value of the business and the owner's goals for transferring wealth and minimizing estate taxes.

Owner's Exit Strategy Is to Bequeath the Business at Death

When children are the designated successors, some owners may choose to transfer their ownership by bequeathing the business to the children when they die. For these owners, their estate plan will become their succession plan. There are a number of issues that must be addressed when the owner bequeaths the business to the successor.

Providing for the Surviving Spouse It is not unusual for the business to comprise the bulk of an owner's wealth. In these instances, it may be necessary to transfer the business to the surviving spouse to provide for that spouse's support. This delays the ultimate transfer of ownership to the children and creates unique challenges that must be addressed by the planner.

If the children are already employed in the business, this structure can create tension between the spouse and the children who are active in the business, similar to when active and inactive children are all owners. In general, the spouse will want as much income as possible from the business (usually in the form of distributions) while the active children may want to make smaller distributions and reinvest as much as possible in business operations. In addition, children active in the business will be able to take cash out in the form of deductible compensation, while the surviving spouse often cannot.

Another challenge is determining who will vote the stock during this period. If the business ownership is transferred outright to the spouse, the spouse will have the right to vote the shares. This can create some problems if the spouse is not competent to vote on business matters. In addition, the spouse may have competing interests with the business and vote the shares in a manner that may not be in the best interest of the business's long term future. If there is a concern about the spouse's ability to vote the shares, the ownership can be transferred to a trust for the spouse's benefit. With a trust, the trustee votes the business shares. Thus, the owner can designate a trustee who is qualified to vote on business matters.

In addition to resolving the voting issues, planners need to develop a plan that will minimize the risk that the surviving spouse will sell or dispose of the business before it is transferred to the children. If the business ownership is transferred outright to the spouse, he or she has complete ownership and is free to sell or transfer it to anyone. Again, it may be best to transfer the business interest to a trust for the spouse's benefit. However, marital trusts must meet specific requirements if transferred property is to be eligible for the unlimited marital deduction. Generally, a marital trust must allow the spouse to dispose of the property (with a general power of appointment or through his or her estate) in order to be deductible. Again, this raises a concern that the spouse may appoint the property to someone other than the intended successor. This concern can often be overcome by using a qualified terminable interest property (QTIP) trust. However, even QTIP trusts have some drawbacks that make them inappropriate in some instances.

Shareholder agreements can address many of these potential conflicts. For example, an agreement can specify compensation limits or formulas, distributions, and debt limitations. Such agreements can also prevent the voting trustee from selling or liquidating the business, terminating an S election, or any other action deemed harmful to the survival of the business.

Perhaps the best method to address these conflicts of interest is to make sure the owner has sufficient life insurance in place to enable the children to purchase the spouse's interest. In this way, the spouse gets liquid assets in the form of sales proceeds funded by the life insurance, and the children retain the business.

Providing Liquidity for the Owner's Estate When the owner chooses to transfer the business at death, its value will be subject to estate tax in the owner's or surviving spouse's estate. Any resulting tax liability can create a liquidity problem for the estate if there are insufficient other assets to pay taxes and other obligations of the estate. Often times, the business must be sold to pay the taxes and other expense, defeating the owner's succession planning objectives. Even worse, the forced sale of the business may not yield true fair value for the business. Thus, planners need to review the estate's projected liquidity needs and develop a plan that will help ensure there will be adequate funds to meet these needs.

There are a number of life insurance products that can be used to help an estate meet its liquidity needs. Thus, several factors should be considered when recommending that an estate acquire life insurance to meet its needs. First, the planner needs to determine the amount of insurance that will be required. (See section 910 for a discussion of determining an owner's life insurance needs.) Once the amount has been quantified, the planner should determine if the owner's age and insurability make insurance a viable option. If so, the planner can review the available products (e.g., universal life, last-to-die, etc.) and funding options (e.g., split-dollar arrangements) in order to identify a product that best meets the owner's needs.

In addition to life insurance, there are several tax deferral alternatives available to closely held businesses that can be used to provide some liquidity relief. Qualifying closely held businesses can elect to pay the federal estate tax attributable to the business on the installment basis over a period of up to 14 years.

There are also special provisions that allow a closely held corporation to redeem its stock to pay the estate tax. If all the requirements are met, the redemption will be treated as a sale eligible for capital-gain treatment (as opposed to a dividend). Since the stock receives a stepped-up basis at the owner's death, there should be minimal taxable gain when sale treatment applies. As a result, the estate can use the redemption to generate funds (usually without any federal income tax) to pay the estate taxes or other expenses.

Other Estate Planning Measures There are numerous estate planning techniques that can be used to facilitate the transfer of a business by removing a portion of the business from the owner's estate (e.g.,a gifting program) or reducing its value (e.g., valuation discounts). These techniques may also be appropriate depending on the value of the business and the owner's goals for transferring wealth and minimizing estate taxes.

CHOOSING AN EXECUTOR OR TRUSTEE

When a person dies, some or all of their property becomes part of their estate. The probate estate is a legal entity that holds title to the assets until they are distributed to the heirs and beneficiaries in accordance with the decedent's will. The executor is the person who executes the provisions of a decedent's will. He or she is responsible for gathering the assets of the decedent's estate; paying all debts, taxes, and expenses of the decedent; and distributing the remaining property to the beneficiaries named in the will. The executor may be an individual, a corporate trustee, or a combination thereof.

A trust is an entity in which the legal ownership and the beneficial ownership of an asset are separated. It is created by a grantor to hold transferred property for the benefit of one or more named beneficiaries. The trust is administered by a trustee who holds legal title to the assets and acts on its behalf for the benefit of the beneficiaries. A trustee may be an individual, a corporate trustee, or a combination thereof.

Choosing an executor or trustee is an important part of any estate planning engagement. However, the process is even more important for the closely held business owner since there may be competing family and business interests. The business owner should consider naming an executor or trustee who has some business expertise when a substantial part of the estate or a trust consists of a closely held business. This helps ensure that estate administration decisions do not adversely impact the business operations.

Characteristics of an Executor or Trustee

Both executors and trustees have a fiduciary duty to act in the beneficiary's best interest. They are also entrusted with the job of preserving and maintaining assets in accordance with the decedent's or grantor's instructions. Thus, they should always be persons with high integrity. In addition to integrity, anyone chosen to serve in a fiduciary capacity should possess the capacity to carry out their designated responsibilities. Executors and trustees are often required to administer estates or trusts with sizeable assets. This may require substantial investment knowledge to help safeguard the assets. Likewise, the estate or trust may own substantial business holdings requiring the fiduciary to possess unique business skills and experience. Thus, it is important to choose a fiduciary who is capable of administering the assets held by the estate or trust.

It is also important to make sure that the person selected to serve has the time necessary to carry out the designated tasks. Even a person who possesses the requisite skills to serve as the fiduciary will turn out to be a poor choice if he or she does not have the time to devote to the task. Likewise, the fiduciary needs to be available and accessible to properly perform their duties. This typically means the person should reside in the same location as the beneficiaries.

Last, the person should be free of any conflict of interest between the estate or trust and the beneficiaries. This problem is typically prevalent for business owners who often require a fiduciary capable of making important business decisions. Often, this limits the list of choices to someone who works in the business. Unfortunately, these people may put the interests of the business ahead of those of the decedent's family.

Special Considerations for Trusts Owning an Interest in the Business

Many times, sound planning calls for transferring ownership in the business to a trust, either during the owner's lifetime or at death. For example, funding a credit shelter trust at death is almost always advised for married individuals. Depending on the makeup of an owner's estate, that trust may have to be funded with interests in the business. Likewise, qualified terminable interest property (QTIP) trusts are useful planning tools because they allow the decedent to provide income to a surviving spouse, defer estate tax until the second death, and control the ultimate disposition of assets.

There are many asset protection and transfer tax saving reasons for transferring interests in the business to a trust, rather than outright to the trust beneficiaries. Using a trust allows the owner to obtain professional management for the business interests (through the selection of a trustee) as well as to keep the interest out of the reach of creditors and to ensure that it is not sold or otherwise transferred out of the family. A gift in trust is also advisable when interests are gifted to a young child, or if there are potential issues with the donee's spouse or ex-spouse. Trusts can be designed to own assets for many generations, thus removing them not only from the donor's taxable estate, but the trust beneficiaries' estates as well. Finally, transferring assets to a grantor retained annuity trust (GRAT) is a popular means for reducing the owner's taxable estate with a minimal gift tax cost.

Whenever business interests are transferred to a trust, there are several special considerations when selecting the trustee and structuring the trust. Note that the same considerations would generally apply to an estate and executor if and when the estate owns the business interest.

Business Considerations Interests in closely held businesses are generally considered to be high-risk investments, and, under some standard trust agreements, may not be appropriate trust assets. Therefore, when a trust will own an interest in the business, its governing instrument should specifically permit the trustee to retain and vote the stock, to elect directors, and to engage in all activities necessary to carry on the business. If there are multiple trustees and any of them are not to have the above-mentioned authorizations, the trust instrument should specify this.

Sometimes, the owner intends for the trustee to manage the business interest on the beneficiary's behalf for an interim period. For example, a succession plan for an owner with younger children may call for a trustee to manage the business until the children gain the experience and maturity to act on their own. At that point, the child might become a co-trustee, with management authority over the business interest while the original trustee retains the management of other trust assets. In this situation, the trust agreement should contain criteria for determining when a child is ready to assume co-trustee authority. The requirements should be objective, and could include completing a certain number of years of employment with the business, obtaining a certain level of education, or being recommended by the board of directors.

Estate Tax Considerations Often, one reason for transferring assets to a trust is to keep the assets out of the business owner's (and in some cases, the beneficiaries') taxable estate. If so, care must be taken when structuring the trust and granting the trustee powers.

It is possible to name a surviving spouse or a child as the trustee without the trust assets being included in that person's taxable estate. Generally, trust assets will not be included in a decedent's estate unless that person had a general power of appointment over the assets at the time of death. A general power of appointment is any power of appointment exercisable in favor of the holder, his estate, his creditors, or the creditors of his estate. General powers include the unlimited power to consume, invade, or appropriate income, corpus, or both for the benefit of the power holder. A holder is not required to have all such powers to appoint property for an instrument to be treated as a general power of appointment. All that is necessary is for the holder to have the power to appoint property to any one of the above. Therefore, planning involves ensuring that any powers over trust assets given the trustee do not rise to the level of a general power of appointment.

Fortunately, there are some clear exceptions that are not considered general powers of appointment. A power that entitles the holder to consume, invade, or appropriate property for the holder's benefit will not be deemed a general power of appointment and, thus, not cause the trust property to be includable in the power holder's gross estate if the power is limited by an ascertainable standard relating to the holder's health, maintenance, education, or support. The terms support and maintenance are not limited to the bare necessities of life, so that this power to use trust assets or income can be quite broad, as long as the use can be shown to meet the standard specified in the trust instrument. This provision is commonly used to avoid inclusion of trust assets in either the trustee's or the beneficiary's estate.

Maintaining Family Control over Assets One way to ensure that the family will have some degree of control over business interests placed in trust is to name the spouse, child, or other family member as trustee. However, there are many situations where that may not be the optimal choice. For example, if one of the goals is to establish a multi-generational trust, the trust must be established in a jurisdiction that does not prohibit trusts in perpetuity. Unless the business owner happens to live in such a jurisdiction, a professional trustee is generally required. Likewise, the family members may not have the business acumen or maturity to serve as trustee, or family dynamics may be such that using a family member as trustee would create unacceptable levels of conflict. When a non-family member is selected as trustee, there are still ways to ensure that the family has some control (or at least, influence) over the trustee's decisions.

One way to keep the family interests represented when business interests are transferred to a trust with a professional trustee is to form an advisory committee consisting of family members. The trustee could then be either permitted or compelled to follow the committee's recommendations. This could also work when one family member is appointed as a trustee, but the business owner wants to ensure that multiple family members are given the chance to have their views heard. Because the family member is merely acting as an advisor and has no power to direct trust income or assets, there should be no problems with inclusion of trust assets in the family member's estate.

Another way for the owner or family members to retain some measure of control over the business after it has been transferred to a trust is to provide for a trust protector, or a committee of trust protectors. A trust protector usually has the power to veto the actions of trustees and to replace trustees for any reason. The protector powers should give the protector influence over the trustee's decisions because trustees do not want to be replaced. Trustees are likely to conduct themselves in a manner that will please the protector when they know that the protector has an absolute right to replace them at any time and for any reason.

Since the protector only has negative powers (e.g., the power to veto decisions of the trustee), the protector has no power to direct the actions of the trustee. Appointing the grantor (or family members) as protector(s) generally should not expose trust assets to creditors' claims, because protectors do not possess powers that would enable a court to reach trust assets. However, applicable law should be consulted to ensure that a grantor is expressly allowed to be a protector to avoid a creditor arguing the trust is a sham.

Possible Candidates to Serve as Executor or Trustee

Surviving Spouse The owner's spouse may be a logical choice to serve as executor or trustee if the spouse is involved in the business. Since the spouse is usually the primary beneficiary of the estate, he or she will often be in the best position to address the decisions involving competing family and business interests (e.g., sell the business to meet current liquidity needs). If the surviving spouse is not the parent of all of the owner's children, it may be best to name someone else as executor or trustee to minimize the potential for conflict that could result between the children and the spouse.

Owner's Children The business owner's children should also be considered as a choice for executor or trustee when they are involved in the business. Often, one or more children will be the intended successor of the business. Thus, these individuals will have intimate knowledge of the business and a vested interest in its future. However, when the owner's spouse or other children are not involved in the business, there may be competing interests between the active child (who wants to preserve the business) and the spouse or other children (who just want their share of the owner's bounty). Likewise, if the surviving spouse is not the children's parent, there could be an increased risk for potential conflict.

Partner or Shareholder The business owner's partner (or another shareholder) or an unrelated business successor may also be considered as a potential executor for the owner's estate. Since these individuals possess the requisite business knowledge to protect the business, they should be considered when the continuation of the business is in the best interest of the estate beneficiaries. However, naming one of these individuals as executor may create a conflict of interest if the beneficiaries are best served by a sale of the business. In these instances, a partner or unrelated successor may act in his or her own best interest (to protect a job or interest in the business) to the detriment of the family.

When a business partner or successor (related or unrelated) has a potential conflict of interest, it may be appropriate to name someone else as executor or trustee, but grant him or her the power to hire outside business advisors. The executor can then consult with the business partner or successor on matters that impact the business. Using an independent executor with the power to hire an outside consultant may eliminate the conflict of interest if there are competing business and family interests.

Corporate Fiduciary A corporate fiduciary provides another alternative to serve as executor of a business owner's estate. It offers the advantage of perpetual existence and professional expertise in making investments and managing assets. Its main disadvantage is cost, which may be too expensive for smaller estates. However, a corporate fiduciary will often provide the best balance of business expertise and impartiality. Note that corporate fiduciaries are unlikely to administer unincorporated businesses or general partnership interests, which would require the fiduciary to be directly involved in the management of the business and become exposed to liability for business debts and obligations.

CLAIMING VALUATION DISCOUNTS

Once the value of the partnership as a whole has been established, the appraiser must determine the value of the specific interest to be transferred. In most family partnerships, such value is not merely the partner's proportionate share of the value of the underlying assets, but the value of the partnership interest itself. The value of the donee-partner's interest is a function of his or her rights and powers (according to the partnership agreement and state law) with respect to the underlying assets, as well as market forces.

Minority Interest Discount A minority interest discount is a downward valuation adjustment reflecting the minority interest owner's lack of control over the partnership's operations. The degree of control represented by such an interest is one of a number of factors on which the property's FMV is based.

A limited partnership agreement can be structured so that (a) a limited partner's ability to redeem his interest is restricted; (b) if a limited partner sells or transfers his interest to someone outside the partnership, the transferee becomes only an assignee (with no management rights, withdrawal rights, or even rights to inspect the books and records) unless all other partners consent to admit him into the partnership; and (c) the general partner is given discretionary control over distributions. As a result, the limited partner essentially owns an illiquid asset over which he has little control. Because of this inability to liquidate a limited partnership interest or command distributions, and because assignees generally have no rights under state law other than rights to receive distributions, a hypothetical willing buyer of the partnership interest would be willing to pay far less than the interest's percentage share of the partnership's liquidation value. This spread between the higher liquidation value and the lower amount the hypothetical willing buyer would be willing to pay is the minority interest discount.

Observation: An inverse relationship exists between minority interest discounts and control premiums that may apply, for example, to an interest in an entity that has control over distributions and the ability to liquidate. Buyers may be willing to pay a premium for such control powers, and frequently do so in corporate takeover situations. Valuation experts often take such control premiums into account and "back into" the amount of minority interest discounts.

Effect of Family Attribution A minority interest discount is not disallowed solely because a transferred interest, when combined with other interests held by family members, is part of a controlling interest. In the case of a gift, this is true even if the donor owned 100% of the business interest prior to the gift(s). However, see the following discussion about the value of the swing vote potential of minority interests.

This may be more beneficial to taxpayers in the gift tax area than with estate taxes. Each gift by a donor is valued separately, even if several gifts are made simultaneously. Accordingly, the tax cost of gifting a controlling interest in a business to family members can potentially be reduced substantially if each donee receives a minority interest. In contrast, estate tax values are determined at the decedent's level. Thus, even though family attribution does not apply, a minority interest discount is not available for estate tax purposes if the decedent owned a majority interest at death.

Swing Vote Potential A partner who owns as little as 2% of a partnership can sometimes exert a great deal of control over the partnership's major actions. If one person owns 49% of the partnership and another owns 51%, the 49% holder has little or no positive control and, in many states, may not even have the "negative control" of being able to block certain actions. However, if two partners own 49% each and a third owns 2%, the IRS may contend that the 2% partner may have a great deal of swing vote potential. Accordingly, the 2% owner may be able to command a considerable premium for that particular interest over a prorata portion of the total partnership, for example, if he decided to sell his interest to one of the 49% owners. However, in True, swing vote premium theory was tested. The court held that it cannot be assumed that the minority interest being valued will be acquired by an existing shareholder who would then become the majority owner. Similarly, it cannot be assumed that the minority interest would be acquired by an unrelated party who would then join with an existing minority owner to exercise majority control.

Lack of Marketability Discount When valuing property for estate and gift tax purposes, it is important to distinguish between a minority interest discount and a discount for lack of marketability. As previously discussed, a minority interest discount relates to the lack of control a minority owner has over the operations and important decisions of the company. In contrast, the lack of marketability discount deals with the illiquidity of an ownership interest (i.e., how difficult it will be to convert the interest to cash if the owner chooses to sell). Even a controlling interest in a nonpublic company may qualify for a lack of marketability discount because of the absence of a ready private placement market and the prohibitive costs of making a public stock offering.

A lack of marketability discount does not automatically apply to every closely held business interest (see, e.g., Neff, in which such a discount was substantially reduced because the company in question had a practice of repurchasing its shares at a premium from departing or deceased shareholders). However, it is generally not difficult to identify the circumstances in which the discount is appropriate.

Combining Multiple Discounts When valuing property for estate and gift tax purposes, it is important to distinguish between a minority discount and a discount for lack of marketability. As previously discussed, a minority interest discount relates to the lack of control a minority owner has over the operations and important decisions of the company. In contrast, the lack of marketability discount deals with the illiquidity of an ownership interest (i.e., how difficult it will be to convert the interest to cash if the owner chooses to sell).

Although the minority and lack of marketability discounts are somewhat related, they are two separate concepts. Both discounts may apply to a single partnership interest. If they do, the discounts can be applied on a cumulative basis, when the second discount is applied to a property's value only after that value is reduced by the first discount, or jointly, when each discount applies to the undiscounted (original) value of the property. If applied jointly, courts have typically favored a single combined percentage rather than assigning a specific percentage to each discount. In contrast, applying the two discounts on a cumulative basis (see the following example) requires they be separately determined and supported.

Retaining Control over Gifted Assets

One of the most attractive aspects of FLPs is the ability to give children or other beneficiaries an interest in valuable property without totally surrendering control over the assets. This attribute makes FLPs useful in situations where relatively wealthy small business clients want to take steps to provide for their children in a tax-efficient manner—while still retaining a significant degree of control over the wealth they have worked so hard to create. Typically, this is accomplished by having the older generation set up an FLP where they (or a corporation or LLC owned by them) are the general partners. The children are given or sold limited partner interests.

SALE OF PROPERTY TO AN INTENTIONALLY DEFECTIVE IRREVOCABLE TRUST (IDIT) AS AN ALTERNATIVE TO A GRAT

A properly structured sale of property to an IDIT [sometimes referred to as an intentionally defective grantor trust (IDGT)] may achieve results comparable to those offered by a grantor retained annuity trust (GRAT).

Defining an IDIT

An IDIT is an irrevocable trust in which the grantor retains enough control to be treated as the owner of the trust for federal income tax purposes but not enough to cause the trust assets to be includable in his or her estate for federal estate tax purposes. If the trust violates one or more of the grantor trust provisions, it is considered a defective trust for income tax purposes (which is the objective here). A transfer to a trust that has grantor status for income tax purposes will nevertheless be a completed gift (provided that the grantor does not retain power to change the disposition of the property) and thus will not be includable for estate and GST tax purposes. In essence, the trust is *defective* for income tax purposes but *effective* for estate tax purposes.

The defective status of the trust results in the grantor being taxed on the income, deductions, and credits attributable to the portion of the trust that the grantor is deemed to own. In addition to taxing the income at the grantor's potentially lower rate (compared to the trust income tax rates that would otherwise apply), the trust corpus is not reduced by the income tax paid, thus allowing for a larger amount to be accumulated in the trust for eventual distribution to the trust beneficiaries. As long as the grantor does not retain ownership powers that would cause the trust corpus to be included in his or her estate, the value of the trust assets should be excluded from the grantor's estate.

How the Strategy of a Sale to an IDIT Works

Initially, the grantor will make a seed money gift to an irrevocable trust. Although most commentators suggest the amount of initial seed money given to the IDIT be 10% of the value of the purchased property, there may be cases where a higher percentage is appropriate, for example, if the assets in the trust are risky and a third-party lender in an arm's-length transaction would require additional equity. The seed money is intended to create additional equity within the trust to avoid any IRS assertion that the note taken by the grantor when property is sold to the trust is, in fact, equity (thus increasing the taxable gift).

After making the gift of seed money, the grantor sells appreciating assets to the trust in exchange for a promissory note. The sale freezes the value of the property in the grantor's estate. Because the trust is a grantor trust for federal income tax purposes, there is no federal income tax on the sale of the property or on the interest income paid to the grantor during the note's term. The note should provide for periodic payments to the grantor (not less than annually) at a market rate of interest determined under the below-market loan rules. The note may allow for a single balloon payment of principal due at the end of the term, as well as the prepayment of principal without penalty. In addition, the note may specify that it is to be canceled upon the death of the seller. This is known as a self-canceling installment note (SCIN).

The property sold to the IDIT should be income-producing property (e.g., a building or equipment leased to the business) that generates adequate income to cover the annual interest payments on the installment note. If the property within the IDIT must be sold to make the annual interest payments, the grantor will recognize any gain on the sale of appreciated assets.

Income Tax Consequences The sale to the IDIT is treated as a nonevent for federal income tax and capital gains tax purposes. Thus, the grantor has no income recognition upon selling appreciated assets to the IDIT for which he or she is treated as the owner. Moreover, the trust takes the grantor's basis in the assets. IDITs generally should not give trust beneficiaries Crummey withdrawal powers.

Put another way, a tax-free sale of appreciated assets to an IDIT can be achieved only when the IDIT is considered to be, for income tax purposes, a grantor trust owned *solely* by the seller/grantor. Since the existence of Crummey powers could cause part of the IDIT to be owned by the beneficiary, such powers are incompatible with the tax-saving idea behind IDITs. The required interest payments on the installment note are ignored for income tax purposes. The trust cannot take a deduction for the interest paid, nor will the grantor be taxed on the interest income received.

Gift Tax Consequences If the sale price is at least equal to the FMV of the property sold and the interest rate on the note is at least equal to the AFR, there is no taxable gift. If the value of the property exceeds the amount of the note, however, a taxable gift will result. Moreover, IRC Sec. 2702 could apply to treat the installment note as a retained interest, thus creating a large taxable gift (particularly if the beneficiaries of the IDIT are family members). If Section 2702 applies, the use of a balloon payment installment note would not be allowed since the payments must be ratable to be qualified interest.

Estate Tax Consequences For estate tax purposes, the installment note is included in the grantor/seller's gross estate. However, the trust assets (and all appreciation since the date of the sale) are removed from the grantor/seller's estate. In some cases, the installment note should be able to be discounted below the face value. However, the estate will have the burden of proof that the discount is appropriate.

Advantages of a Sale to an IDIT Rather Than a Gift to a GRAT

Some of the advantages of using an installment sale to an IDIT rather than a GRAT to transfer property include:

- **Lower Estate Tax Inclusion Value** If the Seller/Grantor Dies before the Note Is Repaid Because Only the Unpaid Balance of the Note Is Included in His or Her Gross Estate. The sale freezes the value of the appreciating property in the grantor's estate by causing future appreciation to escape estate taxes. (After the sale, the grantor owns a nonappreciating promissory note rather than an appreciating asset.) In contrast, all or part of the date-of-death value of a GRAT must be included in the grantor's estate if the grantor dies during the trust term (IRC Sec. 2036 or 2039). (See section 906 for a detailed discussion of the rules applicable to GRATs.)

- **More Flexibility in Structuring the Payments** The requirements for the payment schedule after a sale to an IDIT are more flexible than the rules for an annuity paid from a GRAT. For example, an installment note from an IDIT may call for interest only payments over a long term, followed by a balloon principal payment. In a GRAT, annuity payments cannot exceed 120% of the prior year's payment.

- **Ability to Use a Lower Interest Rate** A sale to an IDIT permits a lower interest rate factor than a GRAT. The installment note can pay interest based on the AFR tables. The GRAT must use the Section 7520 rate (120% of the AFR mid-point), which is always higher. An IDIT passes additional wealth estate tax-free to the beneficiaries if the rate of return on the trust assets exceeds the AFR, whereas in a GRAT, additional wealth passes estate tax-free only if the rate of return exceeds the Section 7520 rate. Thus, with a sale to an IDIT, additional assets can be passed estate tax-free to the beneficiaries.

- **No Estate Tax Inclusion Period for GST Exemption Allocation** The generation-skipping transfer (GST) tax exemption can be allocated on the date of the sale to an IDIT, whereas with a GRAT, the exemption cannot be allocated until the trust terminates.

- **Easier to Eliminate Gift Taxes on the Transfer** With a sale to an IDIT, it is possible to completely avoid gift tax consequences, provided that the sale price is set at FMV of the property and the installment note has an adequate interest rate. With a GRAT, it has historically been impossible to zero out the value of the remainder interest. However, it may now be possible to zero out or nearly zero out a GRAT.

Additional IDIT Advantages

Beyond comparisons with GRATs, IDITs also have the following additional tax planning advantages:

- **IDITs Can Be Used to Buy Life Insurance** Cash in excess of what is required to service the debt owed by the IDIT to the seller/grantor can be used to buy life insurance coverage. Depending on how much cash is available, this may be a more tax-efficient way to buy life insurance than funding an irrevocable life insurance trust.

- **Additional Cash Can Be Contributed** With an IDIT, there is nothing to prevent the seller/grantor from contributing additional cash (and taking advantage of the annual gift tax exclusion when doing so) after the initial funding of the trust.

- **Seller/Grantor Can Be Given Power to Borrow from IDIT** This gives the seller/grantor access to cash inside the trust and provides additional support for the desired grantor trust status of the IDIT for federal income tax purposes.

- **Seller/Grantor Can Retain Voting Control by Recapitalizing Business before Sale to IDIT** When interests in a business entity will be sold to the IDIT, the seller/grantor can recapitalize the entity before selling ownership interests to the IDIT. The seller/grantor can then sell only the nonvoting interests while retaining the voting interests, which may represent only a small part of the equity value of the business. Thus, the seller/grantor can retain voting control, even after selling most of the equity in the business to the IDIT.

When Not to Use This Strategy

Although the sale of property to an IDIT can be a valuable estate planning technique, it will not provide the desired results in all circumstances. The following are situations in which such a sale might be disadvantageous:

1. If the property sold to the IDIT is not likely to appreciate (considering both income and capital growth) faster than the AFR, the opportunity to escape estate taxes on appreciation is lost. (The interest on the note is paid back to the seller/grantor.)

2. If the seller/grantor is likely to need more income than is generated by the note’s interest payments, the sale to an IDIT may not be beneficial.

3. If the property sold to the IDIT does not generate adequate income to pay the required note and interest payments, the trustee may have to return some of the trust assets to the seller/grantor to satisfy the required note and interest payments or find some other alternative to satisfy the required payments.

TRANSFERRING PROPERTY IN EXCHANGE FOR A PRIVATE ANNUITY

A private annuity involves a transfer of property in exchange for an unsecured promise to receive a stream of fixed payments for life. A private annuity is a valuable estate-planning tool in many family transfer situations. Typically, an older-generation family member transfers an appreciating asset (closely held business, real estate, business asset, etc.) to a younger-generation family member in exchange for the transferee’s promise to make fixed, periodic payments for the remainder of the transferor’s life. Structured properly, such a transfer removes the asset from the transferor’s gross estate, as long as the payments terminate upon his death. The transferor receives a steady cash flow stream, and the property can be retained within the family unit. In addition, the transferor is relieved of whatever burdens might be associated with the ownership and management of the property, and his estate will be relieved of the related administration of the property.

In business succession planning, private annuities should be considered to provide funding for a buyout. Unlike the typical seller-financed buyout where the installment note received by the seller is included in the seller's estate, the value of the private annuity is excluded from the transferor's estate since the annuity terminates at his death. Assuming the seller does not outlive the actuarial life expectancy used to determine the amount of the annual annuity, a portion of the business is transferred to a younger generation without being subjected to estate taxes. Conversely, a private annuity will cause the purchaser to pay more for the asset than he would with a straight purchase if the seller outlives the actuarial life expectancy. Thus, private annuities should be avoided if the seller is younger and in reasonably good health.

Income Tax Considerations

The transfer of property in exchange for an annuity typically generates a gain that is recognized ratably as the annuity payments are received over the transferor's life. The overall gain to be recognized is determined by subtracting the transferor's basis in the property from the present value of the annuity, which is determined by using IRS actuarial tables. The overall gain is reported ratably (i.e., on a straight-line basis) over the transferor's life expectancy as of the annuity starting date.

If the property was a capital asset, the gain will be a capital gain. Since a private annuity sale usually involves related parties, no loss will be recognized on the initial transfer because of the related party loss limitations.

In addition to the gain component, each annuity payment will include an ordinary income component, to the extent the annuity payment exceeds the sum of the gain component and the return of investment (i.e., basis) component.

If the transferor dies before the end of his life expectancy, his unrecovered basis (i.e., investment in the annuity contract) is deductible as a miscellaneous itemized deduction not subject to the 2% of AGI limit on his final individual income tax return. If the transferor lives beyond his life expectancy so that his basis has been fully recovered, all additional payments are considered ordinary income.

Since private annuities are technically not installment sales, the requirement that all recapture income be recognized in the year of an installment sale should not apply.

The transferee's basis in the property generally is the fair market value of the annuity payments. If the transferor outlives his life expectancy, the additional payments are added to the transferee's basis. If the transferor dies before the end of his life expectancy, the transferee's basis is reduced to the sum of the actual payments made, and reduced by any depreciation claimed. The loss of the step-up in basis that would have occurred if the property owner had held the property until death must be weighed against the benefits of the private annuity strategy.

If income-producing property is transferred via a private annuity, income taxes may be saved by the family unit if the transferee is in a lower income tax bracket than the transferor. If the property is depreciable, the depreciation deductions can shelter income received by the transferee. Depreciation deductions can be especially attractive if the property was fully depreciated in the hands of the transferor prior to the sale. In addition, the transferor will not be required to recapture depreciation in the year of sale, as would be the case with an installment sale.

USING A SELF-CANCELING INSTALLMENT NOTE (SCIN) TO TRANSFER PROPERTY

One common estate planning strategy involving intrafamily installment sales calls for the note to be canceled upon the death of the seller. Such arrangements are often referred to as self-canceling installment notes, or SCINs. Assuming a sale for adequate consideration, the value of the note is excluded from the seller's gross estate for federal estate tax purposes, since no asset is transferred to another person as a result of the seller's death. To meet this adequate consideration requirement, the cancellation feature must be a part of the note, as opposed to a provision in the seller's will, and the sale must be structured to include a risk premium to compensate the seller for assuming the risk that he might die before the note is paid in full. Such a risk premium usually takes the form of a higher than normal interest rate or a higher sales price and, in any event, should be reasonable and supportable in the event of IRS attack.

If the owner desires to transfer the asset prior to death and needs to receive some consideration in return, the SCIN is an attractive technique to meet these objectives. In addition, a transfer of property in exchange for a SCIN will not be subject to gift taxes. Thus, owners can use it as a vehicle for making lifetime transfers in excess of the applicable gift tax exclusion amount.

The gain triggered by the seller's death should be reported by the estate on Form 1041. The buyer's basis in the property is the original purchase price even though there is a possibility that all payments may not be made. The cancellation at the seller's death has no effect on the buyer's basis.

Intrafamily installment sales allow property owners to achieve a number of estate planning objectives. The sales can be structured to accommodate the seller's cash flow requirements and the buyer's ability to service the debt, while removing future appreciation and income from the seller's estate. However, certain related party limitations may apply, and the step-up in basis at death will be lost. In addition, if the interest rate is less than the prevailing market rate, imputed interest rules may apply.

PLANNING FOR LIQUIDITY

Ensuring adequate liquidity is a critical part of all estate planning. The first objective is ensuring that the estate will have sufficient cash to pay administrative expenses and, if applicable, estate taxes without being forced to liquidate assets. A forced liquidation almost always results in receiving less than what could be realized from a voluntary sale. The second objective is to anticipate and fund the living expenses of the decedent's dependents.

For business owners, generating liquidity in the estate can be especially critical and difficult. Often, the business ownership interest represents the largest single asset in the estate. But, unlike an investment portfolio or real estate, a closely held business is often difficult to sell. Also, it is usually not possible to sell only a part of the business to raise just the amount of cash that is needed. Finally, in addition to realizing less than fair value, a forced sale of the business to raise cash often results in family members employed in the business losing their jobs.

Life insurance is an important component of planning for liquidity. Also, two special tax provisions may help alleviate cash flow problems for estates. The first allows the estate tax attributable to certain closely held businesses to be paid out in installments over up to 14 years. The second allows estates (or heirs) to redeem stock in a closely held corporation (up to the amount of the estate tax and other administrative expenses) with little or no income tax cost.

Observation: Business owners with fellow shareholders or partners often rely on a mandatory buyout of their business interest under a buy-sell agreement to create liquidity in their estates.

Planning for Life Insurance

Calculating how much life insurance a client should carry normally involves analyzing several needs (e.g., liquidity needs at death, the family's need for a continuing income source, and special needs such as funding a college education or caring for a handicapped child). In addition, the planner typically must balance the calculated need with the amount and type of coverage the client can afford.

Once the amount of insurance coverage has been determined, it is advisable to plan to keep the insurance death benefit proceeds out of the decedent's estate for federal estate tax purposes (thus avoiding estate tax consuming a significant portion of those proceeds). Often, the insurance is owned by an irrevocable life insurance trust for this purpose. In some cases, using a partnership or LLC to own the insurance may be appropriate.

Life Insurance Needs Analysis Although each client is unique, following is a list of major cash needs often present at death. All business owners, with their planner's assistance, should quantify these needs and how they will be funded:

- **Family Welfare** Expenses required to maintain the established standard of living for the family for the first six to 12 months after death and to meet any special needs of survivors.

- **Administration Expenses** Probate costs, fees and expenses of the executor and other professionals, and the costs of maintaining the estate's property until it is distributed to the heirs. (Some planners include the costs of the funeral as an administration expense.) For purposes of liquidity planning, administration expenses are frequently estimated as a percentage of the estate. A common rule of thumb is 2%–6% of the gross estate if the executor is to be a family member or friend who will serve without pay. The percentage could be 10% or more if the executor is to be compensated.

- **Funeral and Cost of Final Illness**
- **Indebtedness** Unpaid bills, installment debts, and outstanding judgments, to the extent these debts will be paid off at death. Depending on the interest rate associated with each debt, the executor and family may determine that it is beneficial to continue certain debts and pay off others. The monthly carrying costs of debts that will not be paid in full at death should be included in the estimate of the amount needed to maintain the family's standard of living.
- **Personal Income Taxes** Federal and state income taxes for any unsettled years prior to death and for the year of death. This should also include penalties or interest for unpaid prior year amounts as well as any applicable income taxes on pension distributions.
- **Estate, Inheritance, and Generation-Skipping Transfer Taxes** This includes state death taxes as well as federal estate and generation-skipping transfer taxes.
- **Specific Cash Bequests to Heirs** Cash bequests are governed by the will. However, if a client dies intestate (without a will), state law governs division of the decedent's property. The divisions required by state law could impact the estate's liquidity needs. Thus, for clients without wills, this should provide additional motivation for having a will prepared.
- **Expenses Related to Family Business** If the decedent was actively involved in the operation of a family business, additional funds may be needed to help the business meet payroll and pay operating expenses while replacement personnel are recruited and trained. In addition, cash may be needed to fund a buy-sell agreement or to pay for exercising stock options.
- **Educational Funds** Additional funds may be needed to provide educational funds for the children (or for a surviving spouse who needs or wants to return to the job market.)

Many planners assume that one-time cash needs (e.g., estate tax, funeral and administration expenses, unpaid indebtedness, etc.) will be paid out of the estate's corpus (including any life insurance proceeds) or out of income earned on the corpus before the need arises. However, the owner must make some decisions and assumptions regarding the funding of his or her family's ordinary living expenses. While many owners would like to rely only on the estate's income to fund those expenses (and, thus, pass the assets that produce that income on to the next generation), in some cases, that is just not possible. Depending on the amount of life insurance coverage the owner can obtain and afford, it may be necessary to annuitize the estate's corpus over the survivors' life expectancy. In either case, assumptions made about the survivors' life expectancy, level of expenses (including inflation), and projected rates of return on estate assets will clearly affect the amount of life insurance coverage needed.

Observation: If the owner is obligated to buy out a co-owner's business ownership interest under a buy-sell agreement, the life insurance needs analysis should also include the amount needed to fund that obligation. The first step is to determine the price of the business under the agreement. This will often require an independent appraisal. Next, the owners should collectively decide how much of the buyout obligation will be funded with life insurance. Finally, each owner should then obtain life insurance coverage for his or her share of the agreed-upon buyout price.

Planning Tip: For married couples, a life insurance needs analysis should be performed for both spouses. The loss of a nonworking spouse's services in the home and in child rearing can result in a large economic loss, as someone will normally need to be paid to provide such services. In addition, unless the working spouse remarries, he or she will lose the ability to file joint income tax returns, take advantage of the unlimited estate tax marital deduction, and split gifts to increase the annual gift tax exclusion. Life insurance can help offset these additional costs due to the death of a spouse.

Rules of Thumb It is important to understand that rules of thumb are merely checkpoints for the planner. While they may be useful to estimate an amount, or as a sanity check once a needs analysis has been performed, there is no substitute for a thoughtfully completed life insurance needs analysis.

Some common rules of thumb for determining life insurance needs include—

- Four to six times annual earnings, or
- Insurance, when combined with the clients' current capital base, sufficient to replace 50%–75% of income.