Family Business Succession Planning: Devising an Overall Strategy

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Abstract: *Devising and implementing an effective family business succession strategy requires much more than simply estimating the value of the business and buying life insurance to cover any transfer taxes due or to "equalize" the estate among all heirs. This approach skips too quickly to identifying and solving the client's liquidity need. Two initial considerations must be addressed before any liquidity need can be accurately identified and effectively solved. First is repackaging: considering whether the business's ownership must be restructured to facilitate a more tax-efficient transfer. Next is redeploying: considering what transfer technique is appropriate (beyond simply relying on undiscounted gifts of voting shares during life or upon death). The purpose of this article is to focus on these first two key considerations broadly, noting along the way how various liquidity need solutions can be properly and effectively integrated. When combined, these constitute an overall strategy of repackaging, redeploying, and leveraging.*

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Introduction

Family-owned businesses are critical to the American economy. Recent statistics attribute 40% of the nation's gross national product (GNP) to family businesses. Moreover, it has been estimated that family businesses generate approximately nine out of 10 new jobs. But despite the significant role they play in supporting the nation's economy, only about one in three survives to the second generation. The estimate of successful transfers to the third generation ranges from only 10 to 20%.[1]

The burden of paying various state and federal transferor taxes on the value of the business may be part of the cause. Often, however, the true reason is that a lack of succession planning fails to allow the family to bridge the generation gap by having trained and capable successors in place. It is for this reason that estate planning for the owner of a family business is among the most challenging tasks of an estate planner. Succession planning for a family business requires more than basic estate planning tools. It requires an ability to consider the special rules that impact family business succession plans, identify the unique opportunities for structuring ownership to take maximum advantage of the available transfer techniques, and carefully select which of these transfer techniques, or combination of techniques, best suit the client's needs.

What Is Family Business Succession Planning?

Family business succession planning is essentially the process of creating and implementing a plan for the

family business that is designed to match the financial and psychological needs of the owner, the family and key employees with the needs of the business as a going concern. Succession planning must reconcile current tax, business and liquidity considerations with family relationship issues to achieve a comprehensive plan that is sensitive to the business's current operational needs and the client's long-range estate planning goals.

Although family business succession planning typically involves estate-planning issues, it is much more complex and difficult. The time limits are much more drawn out. It is not unusual to have creation and implementation take a few years because clients are so busy running the business. A primary family business focus of succession planning is shifting control of the enterprise, whereas the goal of estate planning is generally distributing wealth. Succession planning often involves more, and different, techniques, many of which are fraught with tax risk. It also involves the need to have a team of advisers serving the whole family, not just the patriarch and matriarch. Often there is a need to distinguish between children who are active and those who are not active in the business.

The planning team and business owner must focus on issues of ability and competence of successor family members, issues that can be ignored altogether or handled in more subtle ways in general estate planning (i.e., a standard spendthrift provision in an irrevocable trust). Finally, clients should be conditioned to aim for the realistic and practical goal in succession planning of "rough justice" rather than *pure* equality.

In summary, estate planning simply involves observing the goals and desires of the client and developing an estate plan that reflects him or her. When creating a successful family business succession plan, however, the adviser must consider how it will impact the *entire* family, or at least those who are presently active in the business, or who are expected to be in the future.

Special Rules That Impact Family Business Succession Planning

When an interest in a family business constitutes a portion of a family's total wealth, the transfer of a part of the family's estate necessarily involves the transfer of some type of interest in the family business. Whether the family business is transferred by gift, sale or a combination of both, a host of special rules and regulations apply simply because the parties are related. These transfers usually raise special considerations, such as the retention of control of the transferred interest, prevention of the retransfer of the interest outside of the family, shifting of future appreciation, and retention of special tax benefits under Subchapter S of the Internal Revenue Code. The following are examples of some of the special considerations that must be addressed:

- Special Use Valuation—(IRC Section 2032A)
- Estate Tax Payment Extension—(IRC Section 6166)
- Chapter 14—(IRC Sections 2701, 2702, 2703 and 2704)
- Family Attribution Rules—(IRC Section 318)

Purpose and Structure

The goal of this article is to identify the main transfer techniques used to keep ownership and management of a closely held family business in the family, in a manner that is mindful of these special rules. This article addresses owners of closely held businesses who have children that are interested in acquiring and running the business someday.[2]

There are four basic categories of methods by which a family business can be transferred to successors. The senior family owner's interest can be transferred by gift during lifetime, by gift at death, by sale during lifetime, and by sale at death. Although divisible by category, many techniques constitute a combination of these methods. For example, a closely held corporation or partnership can be gifted during lifetime but remain subject to a buy-sell agreement that calls for the descendent or descendents active in the business to purchase all interests, including any nonvoting interests the patriarch or matriarch happened to gift away during lifetime. Accordingly, this article is not strictly divided into these four basic categories. Rather, it follows a three-step process: repackage, redeploy and leverage. This approach is commonly employed by families with large closely held businesses. Many planners

make the mistake of skipping the first two steps because they are time consuming and only serve to minimize the liquidity needs that exists.

Before focusing on solving the client's liquidity need (i.e. before using life insurance to leverage), the planning team and client must focus on the first two steps (i.e. repackage and redeploy). The first step, repackaging, involves considering whether the business's current structure will adequately facilitate the desired succession arrangement. They must design an ownership structure that will facilitate succession, achieve valuation discounts, and minimize transfer tax costs.

Step I: Orchestrating an Ownership Structure to Facilitate Succession, Achieve Valuation Discounts, and Minimize Taxes

Before a planning team can recommend the transfer technique or combination of techniques that would best suit the client, it is often advisable to separate "ownership" of business interests from "control" of them. There are two ways to do this: recapitalizations (into voting and nonvoting shares) and family limited partnerships (into general and limited partnership interests). This is one of the most common first steps in business succession planning, whether the intention is to gift the interest, sell the interest, or transfer it by combination of both. The idea is to reorganize the family business into a structure that separates ownership from control. With an S corporation, this requires recapitalizing the company into voting and nonvoting shares or transferring S corporation assets (not shares) into a family limited partnership. A C corporation, and just about any other form of entity (with the exception of an S corporation) may separate ownership from control by using a family limited partnership. A regular C corporation may also recapitalize into voting and nonvoting common shares, but afterwards the nonvoting shares are usually transferred into a family limited partnership.

Recapitalizations

A corporate recapitalization under Section 368(a)(1)(E), known as an "E reorganization," is a tax-free transaction, provided it is done for a valid "business purpose."[3] This means that tax on the appreciated value of the surrendered stock and/or securities is postponed until the stock and/or securities received are later disposed of in a taxable transaction. A recapitalization involves an internal corporate transaction in which the parent or parents, who usually own a majority of the stock, cause the corporate charter to be amended and create voting and nonvoting common stock. Each parent then exchanges his or her original voting stock for voting and nonvoting stock. Planners typically recommend that a ratio of one voting share per 99 nonvoting shares be created. Thereafter, it is advisable for the senior generation shareholders to enter into a restrictive shareholder agreement that creates rights of first refusal in the event of a transfer of shares outside of the family by any shareholder. Any subsequent transferees or donees should be required to acknowledge and assent to this agreement.

Neither of these actions jeopardizes S corporation status. An S corporation is permitted to have differences in voting rights among its shares without violating the one class of stock rule under Section 1361(b)(1)(D).[4] After recapitalizing, the senior generation will be able to gift or sell a majority of economic ownership in the company while continuing to own a majority of voting rights.[5] Provided the recapitalization is accompanied by a qualified and comprehensive expert appraisal, the nonvoting shares, even though they represent a majority interest in terms of economic rights, will generally be afforded a valuation discount of up to 40% based on lack of control and marketability.[6] Although a control premium may bump up the value of the retained voting shares to partially offset the advantage of the discounted nonvoting shares,[7] meaningful leverage may still be achieved. Once recapitalized, the clients are in a better position to get maximum advantage out of the transfer techniques the planning team ultimately recommends.

Family Limited Partnerships

A family limited partnership has become a popular mechanism for holding title in, among other things, family C corporation businesses, assets of a family S cor-

poration, or an unincorporated family business. The limited partnership form allows for separation of control from equity ownership through the use of general and limited partnership interests.

The estate and gift tax benefits arise from the ability to make gifts and death transfers to family members at meaningful discounts from fair market value, which will be addressed further in the article. Additionally, because of the unique structure of a limited partnership, creditors of partners only receive a "charging order" against the interest as a mere assignee (not a partner). The creditor has no ability to liquidate the interest and is subject to the K-1 tax liability on it.[8] The most notable feature of a family limited partnership, however, is that the senior family members are able to maintain some degree of control over the enterprise without loss of the tax benefits.

The family limited partnership is no different than any other limited partnership. It is formed under the limited partnership law of a state. When used as a family business succession tool, the senior generation transfers their stock or interest in the family business into the limited partnership in exchange for a small percentage of general partnership units, typically no less than 2%,[9] and the balance in the form of limited partnership units. The assets initially contributed to the partnership by each partner should be identified on an exhibit to the partnership agreement itself. The senior generation is then free to make annual gifts of their limited partnership units to younger family members. The objective is to transfer, over a period of time, all of the limited partnership units to children and grandchildren.

Planning pointer for recapitalized companies or family limited partnerships: Over time, the limited partnership units or nonvoting shares that result from the business structures discussed above can be gifted to younger family members at a discount. Where there are multiple descendants and only one, or a few, expect to assume control of the family business, it is advisable to subject the units or shares to a buy-sell agreement before gifting them away. Gifts of units or shares should be memorialized by a certificate that bears a recital indicating they are subject to the buy-sell agreement. The senior generation family members (parents) can now gift these units or shares to all descendants aggressively. To ensure that the units or shares, and by extension the family business can come under the dominion and control of the family member or members who have been picked to run the business, the senior family members could cause insurance on their lives to be purchased by an irrevocable life insurance trust.

The family limited partnership[10] or closely held corporation[11] can finance the purchase of this insurance under a split-dollar arrangement. The family members who desire to control and run the business would be the trust's primary beneficiaries to the extent of their purchasing obligation under the buy-sell agreement. Any excess would be divided equally. If insurance was inadequate, the rest of the units or shares could be purchased on an installment note basis. If the economic benefit costs of the split-dollar arrangement become too burdensome the trust can roll out and reimburse the family partnership or corporation sometime in the future. This rollout is made easier to the extent the units or shares have been gifted away in the meantime. The senior generation's reimbursement has essentially been gifted away to the younger generation at a discount. Any reimbursement dollars would be allocated to the capital accounts of the younger generation or would be on hand for distribution to them.

To revitalize the life insurance policy the younger family members could simply withdraw their share of the reimbursement and each contribute their respective amounts back into the insurance trust so the trustee can invest the dollars back into the policy.

Impact of IRC Section 2036(b)

When contributing stock in a family business to a family limited partnership, planners must exercise caution. IRC Section 2036(b) states that if a descendent transfers stock in a controlled corporation, but retains the right to vote the transferred stock, it will be included in his or her gross estate.[12] A controlled corporation is one where the descendent owned or had the right to vote (with application of attribution rules), at any time after the transfer and within three years of death, at least 20% of the total combined voting power of all classes of stock.[13]

The regulations under IRC Section 2036(b) state that the capacity in which the descendent could exercise power is immaterial. Accordingly, if voting stock of a controlled corporation is contributed to a partnership and the transferor acquires control of the family limited partnership as general partner, the stock would arguably be included in his or her gross estate. One way to avoid 2036(b) is to make the partnership's general partner a separate entity with the ownership spread among several family members so that the patriarch or matriarch does not control the entity. Another alternative is to provide in the partnership agreement that all the partners (general and limited) will vote the corporate stock in proportion to their partnership interest at the time the voting stock was contributed to the partnership. To the extent there are future gifts of partnership interests, there should not be a 2036(b) problem.[14]

Finally, 2036(b) may also be avoided by recapitalizing the C corporation stock into voting and nonvoting stock and only contributing nonvoting stock. For clients who put a high premium on their ability to retain control, this last option is likely the most attractive.

Impact of Valuation Rules of IRC Chapter 14

In addition to Section 2036, it is also imperative that Chapter 14 of the Internal Revenue Code be considered when recapitalizing a family-owned company or when establishing a family limited partnership to own one. Sections 2701, 2703 and 2704 of the Code will apply for valuation purposes to virtually every *inter vivos* and testamentary transfer of interests in family-held corporations or partnerships. Chapter 14 was enacted to abolish certain asset valuation freezes. "Asset valuation freeze," "estate freeze" and "asset freeze" are shorthand expressions for the procedure by which business owners change the structure of their ownership in a business or enterprise to remove all or a substantial part of the future appreciation from their taxable estates for federal estate tax purposes.

Sections 2701 and 2704

Significantly, however, Sections 2701 and 2704 only apply to the extent that senior equity interests and subordinate equity interests are established by the corporation or partnership in question.[15] Differences between voting and nonvoting interests alone are *not* considered senior and subordinate interests.[16] Accordingly, if only one class of stock (or one class of partnership interest) is involved, as in this context, these special valuation rules are not applicable.[17] The recapitalization described above only contemplates a single class of stock. Likewise, the family limited partnership arrangement discussed above only contemplates standard general and limited partnership interests, which also do not constitute two "classes" of stock under Section 2701.[18] Thus, corporations and partnerships with multiple classes of interests (ordinarily referred to as "preferred" interests) invite the restrictions of Chapter 14 and thereby forfeit the traditional minority discount available to single interest entities.

For corporations, a plain vanilla gift of voting or nonvoting stock will not cause Section 2704(a) to apply. Since all rights of the donor have been transferred by the gift of the shares of stock, nothing lapses. For limited partnerships there are several ways to avoid Section 2704(a). A simple way is to have a corporation or trust as the general partner of the partnership. The parent can be the sole stockholder of the corporation or trustee of the trust and thus be the de facto general partner of the partnership. Since the corporation or trust cannot die there will not be a lapse even when the parent dies and control of the corporation or trust passes to the designated successor.

Another relatively simple solution is to have the senior generation general partner own only a small percentage (1% or 2% for example) as general partner in the income and assets of the entity. Even though death would cause a lapse, the value of the general partnership interest to be included in the estate at death of the general partner would be small. Finally Section 2704(b) is easily avoided by utilizing the exception contained in Section 2704(b)(3)(B), which provides that restrictions on liquidation imposed by federal or state law are permissible for valuation purposes. Thus, a plain vanilla limited partnership agreement that simply provides for liquidation in the manner set forth in the statute would prevent application of Section 2704(b).

Section 2703

Section 2703 is broader than Sections 2701 and 2704. Section 2703 states that the value of any property will be determined without regard to any restriction depressing the value of the property.[19] In this context the valuation discounts for lack of marketability, and control will be disregarded unless it can be established that (a) the recapitalized structure or limited partnership is a bona fide business arrangement, (b) it is not a device to transfer property to individuals who are the "natural object of the transferor's bounty" for less than full and adequate consideration in money or money's worth, and (c) its terms are comparable to those of similar arrangements entered into by persons in an arm's-length transaction.[20]

Because of its apparent breadth, the Internal Revenue Service has tried to apply Section 2703 to attack family limited partnerships. Significantly, however, the Service did acknowledge an important distinction between family business and nonfamily business in TAM 9723009:

> The estate argues that the desire to retain assets within the family constitutes a business purpose for the creation of the partnership. Maintenance of family ownership of an operating business has been held to constitute a business purpose for restricting the transfer of interests in the business, on the basis that continued management by the family might ensure harmony in operating the business. (See, e.g., *Estate of Lauder v. Commissioner*, TC Memo. 1992-736, and cases cited therein.) However, in the instant case, the subject matter of the arrangement was not a family operated business with respect to which a strong family relationship had developed over a period of years. Rather, the restricted assets were decedent's residences, liquid investment assets and virtually all his/her personal property. Thus, there was no "business" in existence; and there is no "business purpose" for attempting to maintain the family ownership of essentially fungible and replaceable assets.

Accordingly, the Service appears willing to allow valuation discounts supported by comprehensive, qualified appraisals if the discounts arise from an ownership structure (whether it be a recapitalized corporation or a limited partnership) that is availed of to maintain family ownership of an operating business or restrict the transfer of interests in the business, for the purpose of continuing management by the family and ensuring harmony in operating the business.

Whether recapitalized or structured into a family limited partnership, the nonvoting shares or limited partnership units are discounted in value. Step 1, repackaging, prepares them to be transferred in a more cost-effective manner than otherwise possible.

Step II: Redeploying Ownership of the Family Business

Transfer Techniques for Redeploying

Though they are certainly not indispensable prerequisites, recapitalizations or family limited partnerships are often used in connection with a wide variety of transfer techniques, whether effectuated during lifetime or at death.

Lifetime Transfers

Recapitalizations or family limited partnerships may be used to facilitate a program of outright gifts, or partial gifts via grantor-retained annuity trusts (GRATS) and grantor-retained unitrusts (GRUTS). They may also be used to facilitate various sales transactions using installment notes, self-canceling installment notes, or private annuities, whether the transaction is entered into directly with the successor family member or with an intentionally defective irrevocable trust.

Dispositions at Death

Recapitalizations or family limited partnerships may also be used to set up a plan for the disposal of a shareholder's interest through a Section 302 redemption or a buy-sell agreement. When considering lifetime transfer techniques, advisers should be mindful of how they impact transfer opportunities at death. For example, a

business owner must retain sufficient stock to meet certain percentage requirements if a Section 303 stock redemption, a Section 6166 extension of time for payment of estate taxes in connection with a closely held business interest, or a qualified family-owned business deduction is planned.

Let's address dispositions at death first, not because they are more advantageous, but simply because there are fewer options available. Dispositions at death and dispositions during lifetime should not be regarded as two separate, mutually exclusive alternatives. They can, and often are, commingled. For example, planning a disposition at death under a buy-sell agreement does not preclude lifetime gifts of the interests subject to the buy-sell. Conversely, unpaid installments under a lifetime installment sale are often forgiven at death through gifts or paid in full with life insurance proceeds. Accordingly, though divided by category under this analysis, dispositions at death and dispositions during life should be regarded as two parts of the same mosaic.

Transferring the Family Business at Death via Bequests through a Will or Revocable Trust

Under this alternative, a senior family business owner may transfer a family business to the successors through a will or revocable trust rather than through a buy-sell arrangement. This includes all gratuitous death-time transfers of the family business. Though this appears to be the simplest and most expeditious way to transfer the family business, the following issues should be addressed.

Liquidating Concerns

Consideration must be given to estate liquidity, particularly at the second death when the marital deduction elected at the first death expires. Potentially unmarketable business interests may be included in the gross estate of either the business owner or the business owner's surviving spouse. Liquid assets will be needed to pay death taxes attributable to inclusion of the family business in the estate interest. Estates of even modest value often are exposed to hardship because estate assets in many instances are illiquid. Death may cause the estate to be liable for numerous other expenses, such as the expenses of last illness, burial expenses, liabilities of the decedent, and federal and state income and death taxes. Pecuniary bequests under the will aggravate the liquidity problem. If a substantial portion of the estate is composed of a closely held family business, the estate may have substantial net worth but lack liquid assets with which to satisfy the immediate obligations. The unfortunate consequence of leaving an illiquid estate is that the estate may be forced to sell at unfavorable terms or to borrow money from the beneficiaries, thereby straining the financial positions of the beneficiaries.

Equitable Distribution of Estate Assets

The children who will not be active in the business must be considered. If the business represents a major portion of the owner's gross estate, and the parents intend to bequeath the business to one child, an equitable distribution to all of the children may be difficult. Life insurance purchased through an irrevocable trust can be used to provide liquidity necessary to equalize their estate.

When bequests or transfers at death are contemplated it is important to evaluate the extent to which the family can rely on the various credits, exclusions, and deductions that may apply.

The Applicable Exemption Amount

The applicable exemption amount is a dollar amount allocated to each taxpayer that can be applied against the gift tax and the estate tax. Under the Tax Act of 2001, the exemption amounts between the gift tax, on one hand, and the estate tax on the other, have been separated. The applicable estate tax exemption amount is equal to $555,800 in 2004, which translates into an exemption equivalent of $1,500,000 in 2004. The applicable gift tax exemption is equal to $345,800 in 2004, which translates into an exemption equivalent of $1,000,000. Subsequent scheduled increases are shown in Table 1.

Planning Pointer: The senior owners of the family business (typically parents) should equalize their ownership of estate assets, including interests in the family business, and have credit trust provisions in their wills or

living trusts to maximize this tax-free transfer opportunity. Ownership interests held in the first-to-die's credit trust could be controlled by the successor as trustee. The credit trust provisions should provide for a qualifying subchapter S trust (QSST) if an S corporation is involved.[21] All business interests, whether owned outright by the surviving parent or owned by the credit trust, would be earmarked for distribution to the successor family member. In order to achieve some degree of equity among the active successor and inactive family members, planners ordinarily recommend the senior generation purchase life insurance inside of an irrevocable life insurance trust. The premium can be funded with either annual exclusion gifts in full, with a combination of "advances" and annual exclusion gifts under a split-dollar arrangement, or with no current annual exclusion gifts under a wait-and-see trust.[22]

The Special Use Valuation Provision

For estate transfer tax purposes, Section 2032(A) allows an election to be made to value certain real property using special valuation methods. In general, for estate transfer tax purposes, qualifying real property used in a farm, trade, or business can be valued based upon its current use, and not its highest and best use, if the recipients of the property agree to continue to use the real property as farm property. If the election is made, the reduction in value can be up to $850,000.[23]

Before relying on the reduced valuation provision of Section 2032(A), a family business owner should give serious consideration to the significant restrictions it imposes:

- First, it cannot reduce the estate by more than $850,000 (as adjusted in 2004 for inflation, rounded down to the next lowest multiple of $10,000).
- Second, the real property that is used in connection with the business or farm must be continuously operated by a qualified heir for 10 years after the senior owner's death.
- Third, if the property is sold or the use is discontinued within 10 years the transfer taxes must be recomputed based upon the original fair market value of the property.
- Finally, a qualified heir who receives the property must sign an agreement to be personally liable for the additional tax. It is due and payable within six months after the date of sale or succession of the use.

The qualifications and requirements of 2032(A) restrict its application to a relatively narrow cross section of family-owned businesses.

TABLE 1

Year	Estate Tax Exemption	Gift Tax Exemption	Highest Estate and Gift Tax Rate
2004	$1.5 million	$1 million	48%
2005	$1.5 million	$1 million	47%
2006	$1 million	$1 million	46%
2007	$2 million	$1 million	45%
2008	$2 million	$1 million	45%
2009	$3.5 million	$1 million	45%
2010	n/a	$1 million	highest increase tax rate
2011	$1 million	$1 million	55%

Section 303 Redemptions

Section 303 stock redemptions provide special estate and income tax relief, provided the decedent's adjusted gross estate consists of more than 35% of stock in a closely held corporation. Redemption will be limited to the amount of death taxes and funeral and administrative expenses allowable as deductions to the estate under Sections 2053 and 2054.[24] This technique is particularly favorable for the family corporation because family attribution is not applied and a Section 303 redemption is treated as a sale or exchange that will generally result in no taxable gain because of the available basis step-up.

Section 303 is useful because the family corporation provides liquidity to the deceased shareholder's estate by making distributions in the form of redemption proceeds. Because few corporations can be expected to accumulate sufficient cash for such a purchase, the corporation typically acquires a life insurance policy on the life of the senior owner. The corporation is the owner and beneficiary and pays the premiums. This is generally a better solution to the funding problem than attempting to accumulate large cash reserves over a period of time, selling

corporate assets, or borrowing at high interest rates.

Planning Pointer: Senior family business owners whose stock will be less than 35% of the adjusted gross estate will thus not qualify for redemption under Section 303. Moreover, if the beneficiaries of his or her estate are spouse and children, a stock redemption by the corporation would result in a dividend to the estate (due to the family attribution rules of Section 318, discussed below). A client who fits this profile should consider an employee stock ownership plan (ESOP). Creation of an ESOP would establish an entity that could purchase all or any portion of the stock owned by the estate and not create dividend consequences to the estate. Such a purchase would indirectly give rise to a deduction for the corporation, a deduction it could not take if the purchase had been directly from the estate. Although such an approach has been approved by the Service in at least one private ruling,[25] it is advisable to obtain a favorable ruling in advance of this type of sale. The ESOP could perhaps own a life insurance policy on the decedent to provide liquidity to make this purchase.

Section 6166

The federal estate tax is normally due and payable in cash within nine months after death. Special deferral provisions, however, are available for a closely held business, provided the business interest exceeds 35% of the senior owner's adjusted gross estate, and the senior owner is

- a sole proprietor, or
- a partner in a partnership with 15% or fewer partners (or owning 20% or more of the partnership capital interest), or
- a stockholder in a corporation with 15 or fewer stockholders (or owning 20% or more of the voting stock in a corporation).

If the senior owner's estate meets these requirements, then estate taxes attributable to the business interest may be deferred for four years during which interest only is payable. Thereafter, there is a maximum period of 10 years during which annual installments of principal and interest must be paid.

Before relying on Section 6166 a family business owner should give serious consideration to the following qualifications and restrictions:

- First, the business interest must meet strict qualification standards and percentages in order for the deferred payment provision to be available. Thus, the availability of the deferral opportunity cannot be determined with certainty until the senior owner's death, when it is usually too late to make alternative plans. Unfortunately, the most likely alternative at this point is selling the business to a third party in a distress sale to generate liquidity to pay the estate tax within nine months.
- Second, all remaining payments may be accelerated by the government if either installments or interest payments are not made within six months of the due date. For a significant period of time then, the family business's profits (assuming they continuously have profits) must be used to pay these installments, which undermines the business's ability to invest in infrastructure and business development.
- Finally, the profits of the business that are used to pay the installments are after-tax dollars. For example, a successor family owner in the 35% bracket would require $1.54 of before-tax income in order to pay $1.00 of the estate taxes.

Clients should not overestimate the extent to which the various credits, exclusions and deductions can minimize the concerns raised above. Because of the narrow applicability of these opportunities, a family business succession plan should only rely on transfers at death as a complete plan to the extent the senior generation definitely has adequate estate tax credits, exclusions and deductions to facilitate a transfer-tax-free business succession plan. If they do not, most planners recommend a combination of lifetime transfer techniques (to reduce their dependence on gifts at death) coupled with trust-owned life insurance for liquidity to cover any unavoidable estate tax liabilities or to equalize the estate to be fair to children not active in the business.

Although lifetime transfer techniques are effective ways to reduce the family's dependence on gratuitous transfers at death, this often results in ownership of the

family business being splintered among multiple descendents. Accordingly, planners are often faced with the issue of how these business interests will be recaptured so that the chosen successor or successors are able to assume control once the senior generation is gone. This consideration is especially critical where only one or some of a number of descendents are active in the business and expect to assume control.[26] A buy-sell agreement among family members is an extremely valuable tool in this regard. Subjecting the business interest to a buy-sell agreement allows the splintered interests to be recaptured at some future date by the chosen successor or successors.

Transferring the Family Business at Death via Buy-Sell Agreements

Buy-sell agreements are often recommended to implement a client's business and estate planning goals. For example, a buy-sell agreement may impose restrictions on the transfer of ownership interests in the business to prevent the transfer of a business interest outside a specific family group. Moreover, buy-sell agreements can be used to protect an S corporation election by preventing stock from falling into the hands of impermissible or unqualified shareholders. Finally, in appropriate (and fairly narrow) circumstances, buy-sell agreements can assist or establish the value of the senior family business owner's interest in the business for federal estate tax purposes.

Special Planning Considerations

There are a couple of rules of thumb in structuring buy-sell arrangements, especially when life insurance is the funding vehicle. These rules provide guidance in commonly encountered situations.

Family Corporations—Problems with Stock Redemption

In almost any family-owned corporation, using a stock redemption arrangement may result in dividend treatment rather than capital gain due to the attribution rules. Dividends are currently taxed at a 15% rate; however, after 2008 dividends will be taxed at ordinary income rates. Since capital assets receive a step up in basis upon the death of the owner there would be little or no capital gain at the death of the stockholder. As a result, dividend treatment should be avoided when redeeming a deceased stockholder's shares.

As a general rule, distributions to stockholders are always dividends to the extent a corporation has accumulated or current earnings and profits.[27] There are three exceptions to this rule under IRC Section 302(b). A distribution will be treated as an exchange if 1) it is not essentially equivalent to a dividend, 2) it is substantially disproportionate with respect to the stockholder, or 3) it is a complete redemption of all stock owned by the stockholder.

Although each exception can be quite complicated, a stockholder in a buy-sell situation should be able to meet one of them.

Family Attribution

Although the "complete redemption" exception provides relief in most cases, the attribution rules can cause problems for the family corporation. Under the family attribution rules, an individual is considered to own all of the stock owned by his or her spouse, parents, children and grandchildren (but not siblings).[28] In addition, property transferred to a trust, estate, partnership or corporation could be attributed to the family members.[29] Thus, under a typical scenario where a parent's stock is completely redeemed, the children's stock will be attributed back to the parent. The complete redemption exception is not met, and the redemption may be considered a dividend.

There are two ways to avoid the family attribution rules in a stock redemption situation: (1) make an outright bequest of the business interest, or (2) elect to waive the family attribution rules. The objective in both cases is to pass the business from parent to child. In a stock redemption, this is accomplished by gifting a small amount of stock to the child. Then, when the parent dies, all of the parent's stock is redeemed leaving the child as sole owner. However, using this arrangement may invoke the family attribution rules. To avoid this problem the parent can bequeath the business interest to the child, instead of having the company redeem it.

The simple bequest has many advantages. The same amount of insurance intended to redeem the stock can instead be used for other estate planning needs. For example, it can provide an inheritance to children not involved in the business, since most parents commonly desire to treat all their children equally. The life insurance proceeds could also be used to provide lifetime income for a surviving spouse or provide estate liquidity. The bequest arrangement is simple, involves no agreement and has the added attraction of keeping the insurance out of the estate (by use of an irrevocable trust) if desired.

The second way to avoid dividend treatment is for the family member to elect to waive the attribution rules.[30] Under this provision, the redemption will qualify as an exchange if the following conditions are met:

- The stockholder terminates all his or her interest in the corporation, including any interest as officer, director or employee.
- He or she does not acquire any interest in the corporation during the 10 years following the redemption.
- He or she does not, during the 10 years preceding the redemption, acquire any of the stock redeemed from any person whose ownership would be attributed to him or her under the construction of ownership rules of Section 318, or transfer any stock to any such person who continues to hold stock after the redemption.

Although the waiver conditions can often be met, the waiver of the attribution rules applies only to the *family* attribution rule. The attribution rules of trust and estates (Sections 318(a)(2) and (3)) must also be avoided, making estate planning for redemption of stock in a family corporation extremely difficult. For this reason, using a cross purchase or wait-and-see arrangement, or the outright bequest as detailed/discussed above, is often suggested for family business succession plans.

Fixing Value in the Buy-Sell Agreement

Generally, if the sale price "is determined by application of formula, based on currently acceptable valuation techniques, that reasonably can be expected to produce results that approximate the fair market value as of the time the sale was consummated," then the agreement will be effective in fixing value.[31] Accordingly, for family businesses, acquiring a qualified appraisal is imperative.

Benefit of Fair Market Value

Family members are sometimes obsessed with the idea that they must show a low value for the family business. Intentional undervaluation does the family more harm than good. For example, in the context of estate tax, undervaluation means that surviving family members who inherit the stock will pay more income tax when the property is subsequently sold at fair market value since the basis of the surviving family members in the property will be the undervalued amount reflected on the estate tax return.

If there is a buy-sell agreement in place, the undervaluation could be a disaster at the time of death since the decedent's family will not receive its fair share of the value of the business if insurance funding is inadequate. What family members should concentrate on is making sure they have access to adequate liquidity through life insurance.

Planning Pointer: An effective liquidity strategy for a married couple is second-to-die life insurance owned by an irrevocable trust in which neither spouse owns any incidents of ownership. The insurance should be in an amount sufficient to pay all of the estate settlement costs (estate taxes and administration expenses). The trust may be structured so that none of the death proceeds are included in the estate of either spouse. Although the policy insures two lives, only one death benefit is paid at the time of the second death. This is when the funds are needed since no estate tax is usually due at the time of the first death because of the applicable exclusion amount and the unlimited marital deduction. Additionally, second-to-die life insurance is often less expensive than term life insurance since the policy only pays one death benefit. Second-to-die life insurance is often available even if one of the insured is rated or uninsurable so long as the other spouse is insurable.

The discussion above has analyzed techniques for transferring a family business upon death (whether by will, living trust or buy-sell agreement). For clients with

smaller estates these methods may be suitable. For clients with larger estates, however, deferring transfer until death may prove disastrous. The following discussion will analyze redeployment techniques that can be used to avoid such disasters.

Step II Continued: Disposition of the Family Business during Lifetime

Facilitating a transfer of the family business during the owner's life may have tax and nontax advantages. By transferring the business during the owner's life, the owner can utilize estate planning techniques that can lower the overall gift and estate taxes. Most of these estate planning techniques involve transferring the future growth of the business from the senior generation to the junior generation as quickly and efficiently as possible.

Transferring the business while the original owner is still alive can also have nontax advantages. The older generation will be able to provide guidance on strategic planning, management and operations of the business. The older generation may also facilitate relationship building between the younger generation and employees, customers, and suppliers.

Compensatory Transfers

Compensatory transfers of stock or partnership interests to successors that are employed affords them some degree of recognition for their service and their position as successor owner or owners. This strategy simply involves paying part of the successor's compensation in the form of ownership interests (stock or partnership interests). This reduces the amount they will have to purchase back from the inactive siblings, if any exist. The tax to the successor is offset by the business's tax deduction. Even if a cash bonus is paid to the successor to cover this tax, the total cost to the business, and by extension, the senior generation, will be less than the estate tax/gift tax costs.

Outright Gifts

Outright gifts to family members continues to be an excellent strategy for passing on the family business to the next generation. Gifts of stock in a family-owned corporation or interest in a family limited partnership qualify for the $11,000 annual exclusion (as indexed for inflation).[32] For owners who want to retain control, these gifts could be of nonvoting shares or limited partnership interests. If the business is growing quickly, the senior generation certainly should begin taking advantage of their annual exclusions and perhaps even their applicable exclusion amounts, in order to shift more of the business on a tax-free basis.

From an economic standpoint an aggressive lifetime gifting strategy may be a good idea; gift taxes are lower than estate taxes. If the client's estate tax rate is 48%, it will only cost $480 in gift tax to transfer $1,000 to a child during lifetime. By contrast, it will cost $923 in estate taxes to transfer $1,000 to the same child at death. The reason is that the gift tax is tax exclusive but the estate tax is tax inclusive (meaning the tax amount itself is part of the estate tax base but is not part of the gift tax base). Lifetime gifts also operate as an estate freeze technique: the value of the gift is taxable at its date of gift value, whereas if the senior generation keeps the property until death, the growth is also taxed in their estate. With lifetime gifts, donees enjoy the "growth element" (the future value in excess of the date of gift value) without any gift or state tax paid by the client. A straight campaign of outright gifts, however, tends to result in client inaction due to the large amount of gift taxes that may result.

Loss of Stepped-Up Basis

The loss of a stepped-up basis that results from making lifetime, rather than postdeath, gifts is an important factor to consider and may discourage lifetime gifts of certain properties. The loss of the step up is especially crucial with respect to property that is expected to appreciate significantly before the donor's death. Note however, that if the decedent retains the property until death, the estate may have to pay estate tax on that appreciation in value. Accordingly, the potential capital gains tax savings of the step up must be compared against the estate tax cost of including the property in the gross estate.

Furthermore, in the context of a family business succession plan the potential capital gains tax savings to

the decedent's children is ordinarily not a compelling factor because the children contemplate retaining the business, not selling it.

When clients have some descendents who will be active in the business and some who are not, and they wish to apportion the estate fairly, they commonly make gifts of nonvoting or limited partnership interests to all descendents, but subject them to a buy-sell agreement that enables those who will be active to recover the interests that were gifted to their inactive siblings. Trust-owned life insurance on the senior generation owners provides the younger successor with the liquidity to purchase outstanding interests that have been gifted to inactive siblings.

In spite of the advantage of a taxable gift, many clients do not rely solely on gifts because of the out-of-pocket gift tax cost they incur. If business owners want to transfer appreciating business interests away to deflect the growth outside of their estate but want to avoid paying gift taxes, they can sell business interests to adult children in exchange for an installment note, self-canceling installment note, or private annuity.

Stream of Payment Transfers

Stream of payment transfers refers to installment sales, self-canceling installment notes, and private annuities. These three transfer techniques all involve the transfer of all or a portion of the business interest from the seller to the buyer today with a stream of payments being made from the buyer to the seller over a period of time. The three techniques differ on when the stream of payments ends; installment sales usually end after a term of years, self-canceling installment notes usually end at the earlier of a term of years or the death of the seller, and private annuities end upon the death of the seller.

Installment Sales

Unlike outright gifts or partial gifts, under an installment sale there will be no gift tax due. Moreover, except to the extent of the interest earned on the notes, the notes do not appreciate in value, so an installment sale operates as a freeze that allows clients to deflect growth without paying any gift or estate tax on the growth. Of course, the unpaid balance of the note will be included in the client's taxable estate, unless they minimize the sale with a self-canceling installment note or a private annuity.

Selling the family business to the successor or successors under an installment sale may be one of the simplest succession planning transactions to complete but may also bring some unexpected results. An installment sale is a useful means of transferring the business when the owner's gift tax exclusions have already been used, or when the owner would prefer to receive payments during retirement. This straight installment sale allows the seller to choose who gets the business—and removes the stock from the seller's estate—leaving any future increase in stock value to accrue to the buyer. When the seller uses appreciated property in making the transaction, their gain will be recognized and spread out over a scheduled period of payments. Unpaid balances must bear interest at the applicable federal rate (AFR). Depending on the nature of the asset and activity involved, special deduction limitations (investment interests) may be applicable to the buyer for interest payments.

One drawback associated with the installment sale is that, although it offers family members a more feasible means of purchasing the business, installment sales to related parties are subject to stringent rules[33] including the Section 453(e) resale rule.

Under the resale rule, a second disposition of stock within two years of an initial installment sale to a related party causes (except in certain circumstances) the gain on the original sale to be recognized in the year of the second disposition. Thus, the purchaser's future stock transactions have a direct, negative tax impact on the seller. To balance this seller's tax plan with the buyer's need, the sales contract must be tailored to the specific situation especially when the sale is intended to be made under the installment method.

Self-Canceling Installment Notes (SCINs)

The self-canceling installment note attempts to remove one of the traditional objections to an installment sale—that the present value of the remaining installment payments due under the installment note are

included in the gross estate. A self-canceling installment note is a transaction comparable to the installment sale with two exceptions. First, the scheduled installments continue for the scheduled time period (whatever the term of the note may be) unless the seller dies. At that point, any unpaid installments no longer are required to be made by the acquiring family member purchaser.

The second distinction is that in order to obtain the right to cease payments upon the transfer's death, the transferee must pay a "premium" for the possibility of premature risk of death (that is, the seller negotiates a higher purchase price or a greater interest rate on the note in exchange for including a provision in the note canceling the buyer's obligation to make payments in the event of the seller's death). If the sale is bona fide and for full and adequate consideration and the provision for cancellation is bargained for by the parties, the cancellation provision will remove the value of the note from the seller's gross estate in the event of the seller's death during the installment period.[34]

The Private Annuity

A private annuity arrangement allows a senior owner or owners to hand over the family business to the successor family member of his or her choosing while securing a steady income stream during retirement. It is an arrangement very comparable to a SCIN, but is treated differently for tax purposes. Each element of payment by the transferee represents (1) return of capital (2) an interest factor that is computed from government tables and (3) capital gain from disposition on an appreciated asset. The major difference in the private annuity arrangement (from a SCIN) is the successor family member's agreement to make fixed periodic payments to the seller for the rest of the seller's life (or the joint lives of the seller and the seller's spouse). These fixed periodic payments must continue even if they exceed the fair market value of the property transferred.

A private annuity transaction allows a retiring business owner to transfer appreciated property to a successor family member in exchange for lifetime payments. The transfer of property is not subject to estate or gift tax unless the appraised value of the property and annuity exchanged are not equivalent, in which instance a portion of the transfer would be a taxable gift.[35]

A private annuity is most advantageous when the annuitant is not expected to live out the life expectancy used to determine the annuity rate. Unless an annuitant is clearly near death at the time the arrangement is put into place, the use of the IRS life expectancy tables will be allowed. Thus, a significant portion of the business may pass to family members without the burden of gift and estate taxes. On the other hand, if the annuitant outlives his or her life expectancy, the obligor/family member will pay more than the property's worth.

GRATs and GRUTs

To maintain some degree of management and control over the gifted business interest, many senior business owners use a GRAT or GRUT. While the grantor maintains control of the business interests in the trust, any appreciation subsequent to transferring them in is passed to the younger family member beneficiaries.

The GRAT is an irrevocable trust in which the grantor retains the right to receive fixed payments payable at least annually for life or a term of years. The GRUT is an irrevocable trust in which the grantor retains the right to receive a fixed percentage of the trust's assets payable at least annually for life or a term of years. As property appreciates in a GRUT, the GRUT, by design, returns a portion of this appreciation due to annual revaluing. The GRAT, however, only returns a fixed percentage of the initial contribution. Therefore, GRATs are more effective than GRUTs for transferring appreciating assets.

Accordingly, the downside of GRATs and GRUTs is that IRC Section 2702 requires the *actual payment* of a fixed amount or a fixed percentage, which limits the ability to transfer closely held business interests in trust. To make such payments the trust can use cash flow from the business, or liquidation proceeds from the business interests, or the stock or partnership units of the business.[36]

The value of the gift is the value of the property transferred to the trust reduced by the fair market value of the grantor's retained interest in the trust. The valuation rules of Chapter 14, and specifically Section 2702,

dictate the valuation of the gift for federal gift tax purposes. The donor's retention of management and control serves to discount the value of the gift, rendering it a gift of a future interest. As a gift of a future interest, it does not qualify for the annual exclusion.

Short-Term GRAT

A short-term GRAT is an excellent tool for an older business owner who does not want the risk of failing to outlive a long trust term. It refers to a GRAT approximately two to five years in duration and allows for the "zeroing out" of the taxable gift of the remainder interest that otherwise results. These GRATs contemplate returning a substantial part of the GRAT *corpus* to the grantor to satisfy the grantor's annuity interest. It is unlikely that the grantor will die during the trust term (even shorter with young grantors), because the term is so short. This increases the value of the retained interest and decreases the value of the remainder interest (i.e., the value of the gift). Highly appreciating, low-income-producing assets are the ideal asset for a short-term GRAT. But even if the asset does not appreciate as expected, virtually nothing is lost because the gift is so small. The Service might consider any such transfer in trust for less than five years not to be within the legislative intent of IRC Section 2702, which governs GRATs.

Long-Term GRAT

This simply is any GRAT of a duration longer than a short-term GRAT. A long-term GRAT is typically greater than five years in duration. A long-term GRAT significantly reduces, if not eliminates entirely, the ability of IRS to challenge the arrangement as going beyond the intent of Section 2702. The result, however, is a much higher tax of a remainder interest, depending on its term, and exposes the transferor to 2036(a) inclusion risk if the transferor dies within the selective period for the GRAT's existence (commonly described as "mortality risk").

Joint-Life GRATs

All GRATs and GRUTs, whether short term or long term in nature, can be structured to provide annuity payments over the lives of both husband and wife. This increases the value of the retained interest and decreases the value of the remainder interest gift. The practical consequence is that an annuity percentage may be adjusted upward to cause the present value of the stream of payments back to the grantor to approximately equal the fair market value of the business interests contributed, similar to a short-term GRAT.

GRATs and Family Businesses

GRATs work well with closely held business interests such as partnerships and S corporations. This includes family limited partnerships. As discussed above, these interests afford meaningful initial transfer tax discounts for minority status and lack of marketability interest. Combine this initial discount with the leveraging and discounts afforded by a GRAT and the result is dramatic. The combined effect of discounts for lack of marketability and control is that a lower annuity payout is required, deflecting even more asset appreciation to trust remainder without transfer tax. For instance, instead of gifting an already discounted partnership interest to a child directly, the senior owner of the family business can transfer them to a GRAT. As discussed earlier, however, the Service pays particular attention to valuation discount issues. Accordingly, it is advisable to acquire a qualified, independent appraisal of the closely held interests before contributing them to a GRAT.

Another benefit of a GRAT is that it is a grantor trust. Therefore it can hold S corporation stock as long as the grantor, under the terms of the trust instrument, is the owner of the entire trust for income tax purposes. This is done by identifying the grantor as the owner of both principal and income.[37] This will give the S corporation the ability to yield income on a pretax basis, which makes S stock an attractive GRAT asset.

Other planning opportunities exist when interest in a closely held family business are contributed. The GRAT can be funded with nonvoting stock or limited partnership interest and the grantor can retain the voting stock or general partnership interest. This division allows the senior family members to maintain control of the family business

while transferring the value of the business to their children.

Installment Sale to a Defective Grantor Trust

A defective grantor trust is an irrevocable trust for the benefit of younger family members. The trust is intentionally made "defective" so that the grantor is treated as the owner of the trust for *income* tax purposes under the rules set forth in IRC Sections 671-678. These are known as the grantor trust rules; they are designed to impose income tax on the grantor even though the grantor is not the income beneficiary of the trust. A grantor is the senior family member. The trustee is someone other than the grantor. The grantor sells interests in the family business (income-producing property) to the trust in exchange for an installment note with interest.

The mechanics of the transaction are identical to those involved with the installment note described above. This sale is structured as an interest-only sale with a balloon payment at the end of the term. The interest rate used for the sale (i.e., the applicable federal rate) is found in IRC Section 1274(g).[38] As with the GRAT technique discussed above, the transaction is successful if the assets sold grow or produce income at a rate in excess of the applicable federal rate. Income earned in excess of the installment payment, along with any appreciation in the value of the business interest, inures to the benefit of the trust's remainder beneficiaries. The advantage that the installment sale to the defective trust has over the GRAT is that the AFR is generally *lower* than the rate required under IRC Section 7520 (the rate required in the GRAT transaction), which makes it easier to outpace.

Planning Pointer: If the family business is recapitalized into voting and nonvoting shares or transferred into a family limited partnership, the nonvoting shares or limited partnership interest can be sold at a substantial discount, reducing the trust's payment obligation and increasing the likelihood that the income earned by the trust will surpass the cash needed to pay the note. And since the grantor must pay the tax on the income earned on the trust, the trust's share of the income is undiminished by income taxes. Many advisers recommend that the excess amounts earned by the trust (the amounts beyond what the trust needs to pay the note) are best utilized by leveraging them into the purchase of a life insurance policy insuring the grantor or a second-to-die life insurance policy insuring the grantor and his or her spouse.

Charitable Bailout/Charitable Redemption

Senior family members who would like to transfer a family business to their children during their lifetime are often reluctant to do so because the transfer is subject to gift taxes. One way parents can transfer the business during lifetime and avoid gift taxes is to contribute their stock to a charity or a charitable remainder trust followed by a redemption agreement. In order for this procedure to be successful, the children must own some interest prior to the family business redeeming the interest from the charity or a charitable remainder trust (CRT).

One of the key benefits of the CRT stock redemption combination is that the donor is not taxed on the capital gain when the CRT sells the stock to the corporation. It is possible that the IRS may attempt to attribute the gain to the donor by recharacterizing the transaction as redemption of stock from the donor followed by a gift of the proceeds to CRT. Gain to the grantor can be avoided, however, if there is no enforceable contract that compels the CRT to sell the stock to the corporation.[39]

When structured properly, the possibility of contributing stock to charity and then redeeming it can be an effective succession planning idea.

Technique Chart

Table 2, the Technique Chart, represents a general comparison of the transfer techniques discussed above.[40] It distinguishes between businesses that are and are not S corporations, ones with low and high cash flow, and ones owned by middle-aged and older-aged individuals. The top two items are "repackaging" techniques. The remaining items are "redeployment" techniques.

Technique Chart: Cash Flow Assessment

Any family business succession plan must be sensitive to the cash flow needs and potential of the entity cash

flow. This factor impacts the advisability of every possible succession plan, some positively, some negatively.

When a growing business requires most or all cash that is generated to be reinvested, and this need is expected to persist for a long period of time, there are far less highly efficient techniques to effect successful transfers of either C corporation stock, S corporation stock, or partnership interests. The absence of adequate cash flow limits the owner primarily to an installment sale to a defective grantor trust (memorialized by a balloon note to defer the payment period), or a long-term GRAT. If the senior owner has liquidity outside the business, then one solution is to make taxable gifts. Practically all other applicable techniques, however, are "inefficient" because of the lack of cash flow, with the exception of short- or long-term GRATs for C corporations or short-term GRATS for an S corporation.

If the business requires all cash to be reinvested for the indefinite future, there are few efficient or highly efficient techniques for younger S corporation or C corporation shareholders. The business needs and the shareholder's desire to control result in few acceptable alternatives in either circumstance. If the business generates meaningful cash flow, several more techniques become available. For example, techniques such as outright gifts or GRATs are efficient and appropriate, assum-

TABLE 2

	S-Corporations				Other Entities			
	Inadequate Cash Flow		*Adequate Cash Flow*		*Inadequate Cash Flow*		*Adequate Cash Flow*	
	Middle Age (50)	Older Age (65)	Middle Age (50)	Older Age (65)	Middle Age (50)	Older Age (65)	Middle Age (50)	Older Age (65)
REPACKAGING								
Recapitalizations (voting/nonvoting)	Inefficient	Efficient	Efficient	Highly Efficient	Efficient	Highly Efficient	Highly Efficient	Highly Efficient
Family limited partnerships	N/A	N/A	N/A	N/A	Highly Efficient	Efficient	Highly Efficient	Efficient
REDEPLOYMENT								
Buy-sell agreement	Efficient	Highly Efficient	Efficient	Highly Efficient	Efficient	Highly Efficient	Efficient	Highly Efficient
Compensatory transfers	Efficient	Efficient	Highly Efficient	Highly Efficient	Efficient	Efficient	Highly Efficient	Highly Efficient
Lifetime outright gifts	Efficient	Highly Efficient	Highly Efficient	Highly Efficient	Highly Efficient	Highly Efficient	Highly Efficient	Highly Efficient
Installment sale	Inefficient	Inefficient	Efficient	Efficient	Inefficient	Inefficient	Efficient	Efficient
Self-canceling installment sale	Inefficient	Inefficient	Inefficient	Efficient	Inefficient	Efficient	Inefficient	Highly Efficient
Private annuity	Inefficient	Inefficient	Inefficient	Efficient	Inefficient	Efficient	Inefficient	Highly Efficient
Short-term GRAT (GRUT)	Efficient	Efficient	Highly Efficient	Highly Efficient	Efficient	Efficient	Efficient	Highly Efficient
Long-term GRAT (GRUT)	Highly Efficient	Inefficient	Highly Efficient	Inefficient	Efficient	Inefficient	Highly Efficient	Inefficient
Sale to defective trust	Efficient	Efficient	Highly Efficient	Highly Efficient	Efficient	Efficient	Highly Efficient	Efficient
Charitable bailout	Inefficient	Inefficient	Efficient	Highly Efficient	Inefficient	Inefficient	Efficient	Highly Efficient

ing a younger owner can maintain some control. As discussed earlier, this can be accomplished through recapitalizations into voting and nonvoting interests or establishing a family limited partnership.

The advisability of several techniques changes significantly if the business is growing and the cash flow requirements are significantly less than the cash that is generated. Because cash is available for distribution to owners, several of the techniques become highly efficient for the S corporation, including lifetime gifts and short- and long-term GRATs. Several techniques fall in the efficient range. With regard to a C corporation, many highly efficient approaches exist for non-S corporation entities, especially the family limited partnership that is unavailable to an S corporation because of stockholder restrictions. Taxable installment sales are rendered inefficient because they generate capital gains that could be avoided by use of other techniques. Nevertheless, for entities with adequate cash flow many of the techniques rank efficient to highly efficient.

Technique Chart: Personality and Age Assessment

The technique chart also distinguishes between a healthy, middle-aged family business owner with a relatively high risk tolerance and an older owner with a lower tolerance for risk and a greater willingness to begin ceding control to successor family members.

The older family business owner who has a lower risk tolerance and less need for control will find more techniques that rank efficient to highly efficient. For example, taxable outright gifts, GRATs, SCINS or private annuities have significant appeal, especially when the client's higher mortality is factored in. The older owner, however, is less likely to accept the greater risk and complexity of an installment sale to a grantor trust or a family limited partnership, which is why these are ranked inefficient. The middle-aged business owner, on the other hand, is more likely to reject SCINs and private annuities in favor of long-term GRATs (because the risk of not outliving the term is remote), recapitalizations or family limited partnerships.

The older business owner's higher mortality is a significant factor, whether for outright gifts, a partial gift (as in a GRAT), or sales transactions such as self-canceling installment notes or private annuities.

It is a factor that should not be ignored when assembling a succession plan. For example, the older business owner must consider the possibility that an outright gift may not be a tax-exclusive transfer if, as discussed above, he or she dies within three years of the gift. Similarly, contributions to a GRAT are not considered completed during lifetime if the senior owner dies during the term of the GRAT.[41]

When evaluating a SCIN and private annuity, mortality is also a significant factor because the size of the required payments depends on the seller's life expectancy. With a SCIN, the mortality premium required to establish the successor family member's payment obligation is based on the senior family member's life expectancy. Because of this mortality premium the senior family member may end up with a larger estate than had the SCIN *not* been used. The same risk is encountered with a private annuity if the senior family member lives beyond his or her life expectancy. The successor family member in both circumstances may pay an amount beyond fair market value at the inception of the transaction. These excess payments will be included in the senior family member's estate, adding insult to injury.

Conclusion

Achieving an effective family business succession plan is a difficult task. Because of the differences in all family businesses, and the differences in relationships among family members, each family business succession plan will be unique. If the process is begun early enough and adequate consideration is given to all the factors important to the client, the long odds of a family business not making it to the next generation can be beaten. ■

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(1) See E.F. Koren, "Preserving the Patriarch's Patrimony for the Prodigal and Other Paranormal (or Normal) Progeny: Non-tax Considerations in Family Business Succession Planning," *University of Miami School of Law, Thirty-first Annual Philip E. Heckerling Institute on Estate Planning* 31 (1997): 11.
(2) For an examination of selling the family business to an unrelated third party due to lack of interest or capability on the part of family members, see "Selling the Family Business" by Thomas W. VanDyke, contained in the ALI-ABA Estate Planning course materials journal *Family Business Planning Manual* (1997).
(3) Case law has added certain substantive requirements to the statutory requirements for a tax-free recapitalization. Chief among them is the so-called "business purpose" test, which requires that the transaction serve a bona fide business purpose and not merely be a plan devised for the avoidance of federal income tax. *Gregory v. Helvering*, 293 U.S. 465, 469 (1935); Reg. § 1.368-1(b) and (c). Courts have extended the business purpose test by treating business objectives at the shareholder level, relating to the continuance of the business, as sufficient to support a tax-free recapitalization. Objectives to prevent the corporation from falling under voting control of inexperienced shareholders in case of death of the senior shareholders, or to avoid problems arising from divided control through the ownership of 50% of the stock by two families, *Carnahan v. U.S.*, 188 F. Supp. 461, (D. Mont. 1960), or from the division of control between shareholders who are active in the business and shareholders who are not, have been sanctioned as valid business purposes supporting tax-free exchange treatment of a recapitalization. See, *Dean v. Comr.*, 10 TC 19 (1948); Rev. Rul. 74-269, 1974-1 C.B. 87; see also Rev. Proc. 81-60, 1981-2 C.B. 680 for checklist questionnaire to be used in private letter ruling requests on recapitalizations.
(4) IRC S§ 1361(c)(4).
(5) IRC §2036(b) is avoided in this context because only the transfer of nonvoting stock is contemplated. § 2036(b) only applies to transfers of voting stock. Rev. Rul. 81-15, 1981-1 C.B. 457 is instructive on this point. Beyond 2036(b), planners should also be mindful of Chapter 14 of the Internal Revenue Code.
(6) Rev. Rul. 93-12, 1993-1 C.B. 202; see also *Furman v Commissioner*, T.C.M. 1998-157; *Estate of Brookshire*, T.C.M. 1998-365; *Dockery v Commissioner*, TC memo 1998-114.
(7) See e.g., *Estate of Simplot*, 112 TC No. 13(1999). Control premiums arguably only apply to offset beneficial effects of discounts where actual control of the corporation exists. See e.g., *Trust Service of America vs. US*, 88-1 USTC Para. 13,767(C.D. Calf. 1988), aff'd on valuation issue, 885 F.2d 561(9th Cir. 1989).
(8) Although in certain instances creditors have been successful in having the partnership liquidated in order to reach the underlying assets, see e.g., *Crocker Nat'l Bank v. Perreton*, 208 Cal. App. 3d 1 (1989) and *Hellman v. Anderson*, 233 Cal. App. 3d 840 (1991), in most cases such an outcome is not likely.
(9) The service will not issue any ruling relating to the federal tax status of the limited partnership unless the general partners own at least an aggregate of 1% interest in the partnership, as general partners, at all times. Rev. Proc. 84-67,1984-2 C.B. 637.
(10) See PLR 9639053.
(11) See PLR 9511046, wherein the IRS ruled that the proceeds of a second-to-die policy, owned by an irrevocable trust and funded under a split-dollar agreement with the insured spouses' closely held family corporation, were not included in the estate of the second spouse to die because the corporation possessed no incidents of ownership in the property.
(12) TAM 199938005.
(13) See IRC § 2036(b)(2). Note that the constructive ownership rules under § 318 apply so that shares owned by other family members (spouse, children, etc.) are counted for purposes of the 20 percent rule.
(14) In a corporate context it is permissible to create voting and nonvoting stock and then give away the nonvoting stock. This is analogous to the matriarch and patriarch contributing corporate stock in return for 98% partnership interest in limited partnership units to their children.

Gifting limited partnership units to the children is similar to gifting nonvoting stock. If this is permissible in a corporate scenario it should arguably be permissible in a partnership scenario.
(15) Treas. Reg. §§ 25.2701-3(a)(2)(iii)(1992), and 25.2704-1(2)(vi)(1992).
(16) Treas. Reg. § 25.2701-1(c)(3)(i)(1992).
(17) See IRC § 2701(a)(2)(B); see also Regs. § 25.2701-1(c)(3). A class is the same class as the transferred interest if the rights are identical to the rights of the transferred interest, except for nonlapsing differences in voting rights. Regs. § 25.2701-1(c)(3). The improper structuring of employment agreements or the establishing of preferences for one group of partners versus another causes a valuation to be inadvertently governed by §§ 2701 and 2704, because senior and subordinate interests are created that provide class distinctions between the partners beyond voting rights alone. See TAM 93-52-001 and TAM 19993002 (distribution preference created different classes of equity under § 2701).
(18) If income of a limited partnership is allocated to partners in accordance with IRC § 704(b), § 2701 will not apply. See Reg. § 25.2701-1(c)(3). This means all income allocations must either be, or be deemed to be, in accordance with partners' interests, or have substantial economic effect. The client's tax adviser should maintain the capital accounts in accordance with standard accounting rules, ensure that any distributions in liquidation are in accord with the partners' properly adjusted capital account balances, and that partners have a duty to restore deficits to their capital accounts. See Treas. Reg. § 1.704-1(b)(2).
(19) IRC § 2703(a).
(20) Treas. Reg. §§ 25.2703-1(b).
(21) Although a trust that acquires stock in the S corporation pursuant to the terms of a will is an eligible S corporation shareholder, the eligibility of a will recipient trust lasts only for a period of two years, beginning with the day on which the stock is distributed to the trust. This two-year period of continued eligibility is effective for taxable years beginning after 1996. In earlier years, before the amendment of § 1361(c)(2)(A)(iii) by the 1996 Small Business Job Protection Act, the eligibility period lasted only 60 days from the date on which the stock was transferred to the trust. If a period greater than two years is contemplated, a qualified subchapter S trust (QSST) should be in place. See QSST requirements set out in Reg. §1.1361-1(j)(1)(ii).
(22) Debra Shurson Repya, "When in Doubt, Try the Wait-and-See Trust," *Trusts & Estates,* July 2002.
(23) IRC § 2032A(a)(2).
(24) Because of this limitation, Section 303 redemptions are ordinarily only available (i.e., at the surviving senior business owner's death).
(25) PLR 9646031.
(26) This consideration is far less critical, if not absent altogether, if clients only have one descendent or if they have more than one but all are expected to assume control of the business equally.
(27) IRC §316(a).
(28) IRC §318(a)(1).
(29) IRC §§318(a)(2) and (3).
(30) IRC §302(c)(2)(A). For an excellent example of a properly structured lifetime redemption of a family owned business see PLR 199942018.
(31) IRS Notice 89-99, 1989-2 C.B. 422.
(32) IRC §2503(c). If, however, the controlling interest holder's fiduciary duty to distribute income pro rata is eliminated, directly or indirectly, then the interest in such an entity may not have the requisite "present interest." See TAM 9751003. The gift tax annual exclusion under §2503(b) will be indexed for inflation after 1998. §2503(b)(2), added by the Taxpayer Relief Act of 1997, P.L. 105-34, §501(c). Because the statute requires the adjusted amount to be rounded down to the next lowest multiple of $1,000, it may be many years before the $10,000 annual exclusion is increased.
(33) See A. Gianni "Related-Party Sales Can Produce Unexpected Tax Results," *Tax Lawyer* 26 (Sept/Oct 1997): 75.
(34) *Estate of Frane v. Commissioner,* 98 TC 341 (1992); aff'd in part and rev'd in part, 998 F.2d 567 (8th Cir. 1993).
(35) Rev. Rul. 69-74,1969-1 C.B. 43.
(36) If cash is to be used the family business must have consistent and reliable cash flow. Stock or business interests may be used by the trust to satisfy the annuity payment to the extent that there is not enough cash. This should not trigger capital gain if the property has appreciated in value. Rev. Rul. 85-13, 1985-1 C.B. 184. This a problematic alternative, however, because the stock must be professionally appraised first. Moreover, if discounted stock was originally contributed, this payment method would offset the leverage the clients desired. Finally, the trustee should not rely on a note or series of notes to satisfy the payment obligation, because of the "property" requirement under Treasury Regulation §25.2702-3(b)(1)(i).
(37) See PLR 9525032 (March 22, 1995); Rev. Rule 85-13,1985-1 C.B. 184 (GRATs were grantor trusts under IRC §671-677 and therefore permissible S corporation shareholders under IRC §1361(c)(2)(A)(i)).
(38) The interest rate is required so that the grantor (the senior family member) will not be making a gift. The acquisition indebtedness is equivalent to the fair market value of the acquired property. Informally, however, the IRS has indicated that the trust should have assets equal to 10% of the purchase price to provide adequate security for payment of the acquisition obligation. This means that the note the grantor takes back should equal no more than 90% of the assets contributed.
(39) See *Palmer v. Commissioner,* 62 TC 684 (1974), acq. and aff'd on other issue, 523 F.2d 1308 (8th Cir. 1975) and PLR 9452020.
(40) For an excellent, more comprehensive set of matrixes on this topic see B. M. Abbin, "[S]He Loves Me, [S]He Loves Me Not—Responding to Succession Planning Needs Through a Three Dimensional Analysis of Considerations to be Applied in Selecting From the Cafeteria of Techniques," *Miami Inst. on Est. Planning* 31 (1997).
(41) IRC §2036(a) requires inclusion in the estate. See e.g., IRC §§404(a)(9), 404(k)(1) and 1042. 1996 Small Business Act, §1316(a).