AICPA: BUSINESS SUCCESSION PLANNING
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PART I. ADDRESS THE CONTEXT OF INTRAFAMILY BUSINESS TRANSFERS

A. People, Property, Process, Pitfalls and Plaintiffs

1. It starts with People – be sure to understand the family dynamic.

2. Then – understand the Property – what business entities are there, how are they owned; what are they worth?

3. Planning is a Process – is there a planning team in place? Are the family members on board?

4. There will be Pitfalls – is there unanimity within the family? If the Pitfalls cannot be overcome, there will be Plaintiffs!

B. Key Elements in the Planning Process

1. Recognize that it is always about Control.

2. Recognize that it is often about Denial.

3. Recognize that the client often makes a wrong assumption: "I have a family, so I have a succession plan".

4. Recognize that Conflict may be inevitable if there are Insiders (Plunderers) and Outsiders (Parasites).

C. Some Realities of Family Business Succession

1. Death and incapacity will occur.

2. The estate tax is not going away.

3. There is no "equity value" in the family business – i.e. it is an illiquid asset.

4. Conflict is inevitable.

5. If the heirs to the business grow the business, they increase their own problems.

6. Tax problems are passed from one generation to the next – and often get

worse.

7. Divorce will happen.

PART II. <u>GIVE THE BUSINESS TO FAMILY MEMBERS</u>

I. <u>Recognize the Difficulties of Transferring a Family Business Through Multiple Generations</u>

A. Is There a Succession Plan?

1. Are there capable family members?

2. Has a successor been chosen – has any training occurred

3. Are there rivalries within the generation of likely successors?

4. How will family members outside the business be treated?

B. Has the Business Owner Diversified His or Her Assets?

1. Are there assets equivalent to the business value to be left to other heirs?

2. Have issues regarding support of a surviving spouse and payment of estate and inheritance taxes been addressed?

II. <u>Address the Value of the Business</u>

A. "Fair market value" of a closely-held business is the price that a willing buyer and a willing seller would agree upon. Reg. 20.2031-1(b).

B. With no public market, numerous factors enter into the valuation of a business. Rev. Rul. 59-60, 1959-1 CB 237. Absent a buyer and a seller, the valuation issues are often highly controversial.

C. Appraisals by independent, certified third parties are highly recommended. Book value is not an acceptable measure of the value of a business. <u>Estate of True v. Commissioner</u>, 390 F.3d 1210 (10^{th} Cir. 2004).

D. <u>Consider Valuation Discounts</u>

1. Minority interest discount (lack of control).

2. Lack of marketability discount (absence of a ready market for the business interest). <u>Mandelbaum v. Commissioner</u>, TC Memo 1995-255; aff'd 91 F.3d 124(3^{rd} Cir. 1996).

3. The built-in capital gain discount. This is available where the business could not be sold without triggering capital gain liability. Eisenberg v. Commissioner, 155 F. 3d 50 (2nd Cir. 1998); Estate of Jensen v. Commissioner, T.C. Memo 2010-182.

4. Be sure that the structure of the business supports valuation discounts (LLC, S corporation, family limited partnership, non-voting stock, etc.)

E. In determining the value of interests in a family-held business, family control is disregarded in applying a minority interest discount for lack of control. Each piece of the transferred interest may be viewed separately and distinctly. Rev. Rul. 93-12, 1993-1 C.B. 202.

F. Consider the use of a "defined value gift" in order to lock in a value without committing to a number of shares, units, etc. being transferred Wandry v. Commissioner, T.C. Memo 2012-88 permitted such a transfer without there being a charitable beneficiary to receive whatever was not transferred to family members, as was the case in Petter v. Commissioner, 653 F.3d 1012 (9th Cir. 2011); Christiansen v. Commissioner, 586 F.3d 1061 (8th Cir. 2009) and Hendrix v. Commissioner, T.C. Memo 2011-133. All of these cases are taxpayer victories. The IRS has issued a Nonacquiescence (2012) in Wandry.

G. Recognize that valuation is one of, if not the prime audit topic when a closely-held business is transferred. Be aware that the Obama Administration has recommended amending Code Section 2704 to eliminate some discounting by providing that certain "applicable restrictions" will not lead to discounts, and that there are a number of legislative proposals in Congress to limit discounting opportunities, especially for family business transfers.

III. Address the Federal Gift Tax Rules

A. Marital Deduction

The unlimited gift tax marital deduction is available for transfers to a United States citizen spouse. Code Section 2523. (Gifts to a non-citizen spouse are deductible to the extent of $143,000 for 2013 – annually adjusted for inflation). This may defer transfer tax liability – but may not eliminate it.

B. Annual gift tax exclusion for gifts of present interests in property

1. The annual gift tax exclusion is $14,000 per donee for 2013. Code Section 2503(b). Spouses may split their gifts and give $28,000 to each donee per year, regardless of which spouse is the donor of the gifted property. Code

Section 2513. The annual exclusion is not cumulative – it is "use it or lose it".

2. Be sure the gift creates a true "present interest" in the donee (right to income, right to control, dispose of property, etc). A too restrictive gift will result in denial of the present interest exclusion. Hackl v. Commissioner, 118 T.C. 279 (2002); aff'd 335 F. 3d 664 (7th Cir. 2004); Price v. Commissioner, T.C. Memo 2010-2, Fisher v. United States, 105 AFTR2d 2010-1347 (DC So. In. 2010) However, a taxpayer was able to distinguish these cases and have a present interest exclusion allowed in Wimmer v. commissioner, TC Memo 2012-157, where annual income distributions were made to cover the limited partners' tax liabilities.

C. Consider the lifetime gifting exemption

1. The American Taxpayer Relief Act of 2012 ("ATRA") made permanent the lifetime gift tax exemption at $5 million, indexed for inflation after 2010. There is a lifetime cumulative gift tax exclusion of $5,250,000 for 2013. The annual exclusion gifts mentioned above do not count toward the use of the lifetime exemption. Consider transferring non-voting shares of a corporation.

2. By splitting gifts, a married couple has a combined available exemption of $10.5 million for transfers made in 2013. The portability rules make it possible to preserve this exemption for a surviving spouse.

D. Note the income tax basis rules

1. A donee takes a carryover basis for income tax purposes from the donor. Code Section 1015.

2. Except in 2010 with the modified carryover basis rules if the executor of the estate elects to opt out of the federal estate tax, an heir takes a fair market value at date of death (or alternate valuation date) basis for income tax purposes from a decedent.

E. Be Aware of the Code Section 2036(b) "Trap"

1. The retention of voting rights in a controlled corporation (defined as the right to vote at least 20 percent of the stock) is considered a retained interest in the enjoyment of the transferred property.

2. The attribution rules of Code Section 318 apply here.

3. A three-year look back test is applied here upon the transferor's death to see if these rights were relinquished within three years of death.

IV. <u>If the Owner Dies Owning the Business, Address Liquidity Issues</u>

A. <u>Sources of Liquidity: Code Section 303 Redemptions to Pay Death Taxes</u>

1. Since redemptions are often necessary to pay death taxes attributable to stock ownership in closely held corporations, Congress enacted a special relief provision, Code Section 303.

2. Section 303 treats as an exchange (and not a dividend) a redemption of the decedent's stock so long as more than 35% of the decedent's adjusted gross estate consists of the stock of the closely held corporation.

    a. The "adjusted gross estate" means the gross estate less allowable deductions for funeral and administration expenses, debts and losses. Code Section 303(b)(2)(A).

    b. The stock contemplated by Section 303 may be common, voting, preferred or non-voting. Reg. 1.303-2(c)(1).

    c. Stock of both C corporations and S corporations may be used in a Section 303 redemption. Code Sections 1368(e); 1371(a)(1).

3. If the threshold requirements of Section 303 are met, to what extent may the redemption be utilized?

    a. The redemption distribution is treated as a distribution in full payment in exchange for the stock redeemed to the extent of:

        i. The estate, inheritance, legacy and succession taxes (Federal, state and foreign) (including any interest collected as a part of such taxes) imposed because of the decedent's death; and

        ii. The amount of funeral and administration expenses allowable as deductions to the estate. Code Section 303(a)(1).

        iii. A note from the corporation may be used to satisfy the requirements of Code Section 303.

4. In testing the 35% of the estate threshold requirement of Section 303, aggregation of interests in several closely-held businesses is available.

   a. Where the decedent's gross estate includes stock in two or more corporations with respect to each of which 20% or more of value is included in the decedent's gross estate, these stock interests can be aggregated to reach the 35% level. Code Section 303(b)(2)(B).

   b. However, stock deemed to be owned by the decedent only through the attribution rules of Code Section 318 cannot be so included.

Planning Consideration:

Be wary of an unintended dilution of the family business interest. If the family owns 100% of a business interest, this will not be a problem. However, if two families, for example, each own 50% of the stock of the business, any redemption of voting stock from one family will create a loss of control situation for the redeeming family.

   a. To prevent this result, and while all necessary parties are alive (particularly the senior members of each of the two families) non-voting stock should be created by means of a simple tax-free recapitalization. This can be done for both C and S corporations.

   b. When a death occurs, the stock to be tendered by the decedent's estate to the corporation should be the non-voting shares. In this manner, the family of the decedent could complete the Section 303 redemption and obtain the needed funds from the business, while at the same time, retain and preserve the 50/50 voting stock ownership and control situation.

B. **Sources of Liquidity: Code Section 6166 Installment Payments**

1. Often, the most significant liquidity need of an estate is its liability for federal estate taxes. These taxes are due nine months from the date of the decedent's death. Recognizing that closely-held businesses are likely to face serious liquidity problems, and attempting to create a relief provision to make it unnecessary to sell the business interest to pay death taxes, Congress enacted a relief provision to permit the deferral of estate tax payments. Code Section 6166.

2. Section 6166 is available only if the decedent was a U.S. citizen or resident at the time of death and the value of the decedent's interest in a closely-held business exceeds 35% of the value of the decedent's adjusted gross

estate (defined in the same manner as under Code Section 303). Code Section 6166(a)(1).

3. If these tests are met, the personal representative of the decedent's estate can elect to defer completely for 5 years payment of the portion of the estate taxes attributable to the closely held business interest (multiply the total estate tax liability times the ratio of the value of the business interest to the value of the adjusted gross estate) and thereafter pay the deferred portion of the estate taxes in up to 10 annual installments. The estate tax attributable to non-closely held business assets is due at the regular time, i.e. 9 months from the decedent's date of death.

   a. In applying these tests, passive business interests and passive business assets are not counted. Code Section 6166(b)(9). Where the business involves the management of investment assets, it does not qualify as a closely held business for purposes of Code Section 6166. Rev. Rul. 2006-34 liberalized the availability of Section 6166 for persons holding real estate investments and engaging in some active management of those investments.

   b. A closely held business is more broadly defined than just a corporate interest under Section 6166. A proprietorship, a partnership or LLC (provided 20% or more of its capital is in the decedent's gross estate or if the partnership/LLC had fewer than 45 partners/members) and a corporation (if 20% or more of the value of its voting stock is in the decedent's gross estate or if the corporation had fewer than 45 shareholders) may each qualify as a closely held business interest. Code Section 6166(b)(1)(A) through (C).

   c. Interests in two or more closely held businesses which do not independently meet the 35% threshold test may be aggregated for purposes of that test if 20% or more of the value of each is included in the decedent's gross estate. Code Section 6166(c).

   d. Stock owned jointly or as community property with a spouse, and stock owned by attribution from family members all count toward the 35% test. Code Section 6166(b)(2)(B)-(D).

4. Interest is charged on the unpaid balance of the installments of tax that are due.

   a. The interest rate is 2% for interest payable on the deferred tax attributable to the first $1 million in taxable value of a closely held business (i.e. the tax attributable to the first $1 million in value in excess of the unified credit and other available credits). Code Section 6601(j). Both the 2% rate and the $1 million are to be indexed annually for inflation for decedents dying after 1998. (For 2013, the 2% rate remains, and the threshold is $1,430,000).

b. Interest on the deferred tax in excess of the 2% portion is payable at a rate equal to 45% of the annual underpayment rate established under Code Section 6621. Code Section 6166(j)(1)(B).

c. The tax can be prepaid at any time without penalty.

5. The interest payments made by the estate are not deductible as an estate administration expense for estate tax purposes (Code Section 2053(c)(1)(D)), nor are they deductible for income tax purposes. Code Section 163(k).

6. In order to obtain the benefits of Section 6166, an election must be made on Form 706 no later than the time for filing the federal estate tax return, including extensions. Code Section 6166(d).

7. Acceleration of the installment payments will occur if certain prohibited events take place. If an acceleration occurs, the Section 6166 extension of time for payment of tax ceases to apply, and the balance of the tax which was payable in installments becomes payable upon notice and demand from the IRS. Code Section 6166(g)(1). Acceleration events include the following:

a. A distribution, sale, exchange or other disposition or a withdrawal of capital from an interest in a closely held business that exceeds 50% of the value of that interest. Code Section 6166(g)(1)(A). Transfers to the decedent’s beneficiaries under wills and trusts are not prohibited by this rule. Code Section 6166(g)(1)(D).

b. An exchange of like kind property in a non-taxable exchange where the property received is put to the same use as in the electing trade or business is not an accelerating disposition. PLR 8304033.

c. However, failure to pay principal or interest due under Section 6166, more than 6 months beyond the date fixed for its payment, including extensions, is an accelerating event. Code Section 6166(g)(3)(A), (B).

8. A bond may be required to be posted to secure the payment of the deferred tax under Section 6166 in an amount up to twice the extension amount. Code Section 6165. The IRS may not require a bond in every case. It may

require instead a special lien procedure. Code Section 6324A.

9. Be careful if a business interest for which a Section 6166 election was made is sold on an installment basis. The sale of the interest may involve more than 50% of its value, resulting in an acceleration of all of the unpaid installments of tax. Did the seller receive a large enough down payment to cover payment of the balance of the death tax liability?

V. <u>Consider Advanced Estate Planning Techniques to Freeze the Value of the Business and/or Transfer it to the Next Generation</u>

<u>Issue</u>: ATRA made the estate tax exemption $5 million per person, indexed for inflation since 2010 – with a 40% tax rate on the excess value in a person's estate. The portability of the deceased spouse's unused exemption amount has been made permanent.

A. <u>Estate Freezes: The Self-Canceling Installment Note (SCIN)</u>

1. A business interest may be transferred at a potentially reduced transfer tax liability by utilizing the SCIN transaction. The SCIN involves the sale of property (typically to children) in exchange for an installment note calling for a specified number of fixed payments at a specified interest rate over a set period of time, but also provides that the note payments terminate upon the death of the seller. The term of the note may not extend beyond the seller's actuarial life expectancy. Since death terminates the seller's right to receive payments, there is nothing of value to include in the seller-decedent's estate. Clearly, this can be a significant estate tax benefit to the senior business owner, and an opportunity to the younger generation buyer to actually pay less for the business interest than it may be worth if the senior person does not live long enough to collect all of the note payments.

2. The presence of this termination feature of the SCIN raises gift tax concerns, as it appears that the value of the note may be less than the value of the transferred property. The gift tax issue is avoided by reflecting the self-canceling feature as part of the bargained-for consideration for the sale, by either placing a premium on the price to be paid for the business interest or by stating an interest rate for the note substantially above the market rate. In an environment of low interest rates, this interest rate "premium" becomes an attractive planning opportunity.

3. The Tax Court has held that since the note, by its terms, is canceled by the

noteholder's death, the value of the note is excluded from the decedent's estate. Estate of Moss v. Commissioner, 74 T.C. 1239 (1980); acq. 1981-1 CB 2; Cain v. Commissioner, 37 T.C. 185 (1961).

4. The termination of a SCIN does have potentially adverse income tax consequences. The unrealized or unreported installment sale gain (if there is any, depending upon the seller's income tax basis in the property sold) must be reported as the result of the seller's death. The Eighth Circuit held that the gain should be reported on the fiduciary income tax return for the decedent's estate on the basis that the deferred gain was income in respect of a decedent transferred by the decedent's estate. Frane v. Commissioner, 98 T.C. 341 (1992); reversed, 998 F. 2d 567 (8th Cir. 1993).

5. When considering the use of a SCIN, keep in mind that the use of a premium price or premium interest rate suggests that the seller should not be alive to actually receive the bargained-for premium. In fact, the SCIN works "best" if the seller does not survive the term of the note. As a general rule, the sooner the seller dies after the business interest is transferred, the less the buyer must pay, and the greater the tax benefit realized. Accordingly, SCIN transactions are most often used for those persons whose actual life expectancy is expected to fall short of their actuarial life expectancy. However where death is expected to be imminent, the SCIN will not work, as the IRS is allowed to disregard the actuarial tables in such circumstances. The actuarial tables must be used provided it can be shown that the seller has at least a 50% probability of surviving for more than one year from the date of the sale (Reg. 20.7520-3(b)), even if the seller has a medical condition suggesting a true life expectancy less than the IRS Tables.

6. The SCIN technique was affirmed by the Sixth Circuit in Estate of Costanza, 320 F. 3d 595 (6th Cir. 2003) reversing the Tax Court (TC Memo 2001-128). The Court held that the conveyance of property by a donor's revocable trust in exchange for a secured self-canceling installment note executed by the donor's son was a bona fide transaction, not a taxable gift.

B. Estate Freeze Transactions: The Private Annuity

The private annuity is a planning transaction that may work successfully when there is a business owner who wants to transfer the business interest and continues to receive income, but who may have a reasonably short life expectancy, certainly less than his or her actuarially calculated life expectancy.

1. In the private annuity transaction, the business owner (transferor) transfers ownership of the business to the family member (transferee) in exchange

for the transferee's promise (which must be unsecured) to make payments to the transferor for life. Ideally, the transferee is able to make the annuity payments from a source other than the transferred property itself. Otherwise, the IRS may be able to argue that the transferor has merely retained a life interest in its income, thus requiring the inclusion of the transferred property in the transferor's estate. Code Section 2036.

2. Note, however, the effect of the 2006 Proposed Regulations that would require the transferor of the business interest to recognize the entire realized gain for income tax purposes at the time of the exchange. IR 2006-161;
Prop. Reg. 1.10011(j)(1); Prop. Reg. 1.72-6(e)(1).

3. If the private annuity is structured successfully, there is no gift tax cost and the value of the annuity is not included in the annuitant's estate under Code Section 2039, since no payments continue after the annuitant's death.

    a. If the present value of the right to receive the payments for life equals the value of the transferred property (Note: the annual payments must be sufficiently high to allow this to be the case), the transfer is for adequate consideration, no gift has been made, and the transferred business interest is out of the transferor's estate. Code Section 2036.

    b. If the annual annuity payments are too low, the transferor will be deemed to make a gift to the transferee, since the transferor will not be able to recover the full value of the transferred property (plus an interest factor) within his or her expected lifetime.

4. If the annuitant has a short actual life expectancy the private annuity "works best" for estate tax purposes, since a relatively small amount of funds are paid to the annuitant for a relatively short period of time. The actuarial tables are ignored where a death occurs within one year of creating a private annuity, and survival for eighteen months is a safe harbor. Regs. 25.7520-3(b)(3). Conversely, if the annuitant outlives his or her actuarial life expectancy, the transferee will overpay for the business interest.

5. The proposed regulations taxing the transaction from its inception have obviously limited the appeal of the private annuity as a planning technique. However, if the annuitant's basis is high (such as a stepped-up basis received by a surviving spouse) the private annuity remains a viable planning alternative.

C. <u>Estate Freeze Transactions: Grantor Retained Interest Trusts</u>

A family business owner may be willing to part with the economic asset that is the business, and may be willing to give away the future appreciation in that asset. However, the owner may require or desire some ongoing return from the business, for at least some reasonable period of time, and the owner may further wish to maintain some measure of control and influence over the ongoing management of the business. The owner may not be in a position to afford to pay a substantial immediate transfer tax cost.

The transfer techniques discussed to this point do not satisfy all of these requirements of this business owner. The outright gift accomplishes the transfer of the property and the donee's accompanying opportunity for appreciation, but the gift tax cost may be high, and the gift transaction does not allow the owner any return on or control over the transferred property. The SCIN looks promising, in that the business asset is transferred, future appreciation has been severed, the seller/annuitant is entitled to a generous cash flow and no transfer taxes are due. Control, however, is lost, and the client may be "too healthy" for a successful SCIN.

The client wants something safe and secure from a tax planning standpoint that will accomplish everything the client requires–a classic "have your cake and eat it" request. But here good news is possible. A well-conceived grantor retained interest trust may accomplish everything the client desires.

1. Code Section 2702 provides special rules to determine the amount of a gift when an individual (our business owner) makes a transfer in trust to or for the benefit of a member of the individual's family (our younger generation) and the individual (the owner) retains an interest in the trust.

    a. If Section 2702 is found to be applicable to a transfer, and none of the exceptions to Section 2702 coverage apply, then the interest retained by the transferor (the owner) is valued at zero. This means that the entire fair market value of the transferred property in which the transferor has retained an interest is subject to gift tax as of the date of the transfer. (Not the result we want.)

    b. Conversely, if an exception to Code Section 2702 is applicable, the retained interest is recognized as "qualified," so that the amount of the gift is measured by the fair market value of the transferred property <u>less</u> the value of the interest retained by the transferor. Code Sections 2702(a)(1), (a)(2); Reg. 25.2702-1(b).

2. Clearly, the goal here is to qualify for a Section 2702 exception so that the owner can transfer a business interest to his or her intended beneficiaries,

retain a desired interest in such transfer, and be allowed to value the transfer for gift tax purposes by subtracting the value of the retained interest from the fair market value of the property on the date of the gift.

3. A “qualified interest” includes any interest which consists of the right to receive either fixed amounts payable at least annually or the right to receive annual payments of a fixed percentage of the fair market value of the trust property as determined annually. Code Section 2702(b).

4. A grantor retained annuity trust (GRAT) and a grantor retained unitrust (GRUT) are the planning vehicles that have emerged in response to these rules.

   a. These are irrevocable trusts to which the trust grantor (the business owner) transfers property (some part of the business interest) while retaining the right to receive an annuity or unitrust interest (i.e. a “qualified interest” within Code Section 2702) for a fixed term of years. When the term of years expires, the property passes to the designated remainder beneficiaries of the trust (the business owner’s children).

   b. The transfer tax advantage of GRATs lies in the ability of the grantor to transfer property to the remainder beneficiaries at a significantly reduced tax cost since the actuarial value of the grantor’s retained interest is subtracted from the value of the property placed in trust in order to determine the value of the transfer for gift tax purposes. The larger the retained interest (a function of the grantor’s age, the duration of the trust, prevailing interest rates, and the selected fixed percentage retained payment) the smaller the taxable gift of the remainder interest.

      Note: The Tax Court has held that it is possible, in the properly designed actuarial circumstances, to create a “zeroed out GRAT”, i.e. one that results in no taxable gift to the grantor’s beneficiaries based on the valuation of the retained interest of the grantor, but still allows the transferred property to be removed from the grantor’s estate if the grantor survives the term of the trust. Walton v. Commissioner, 115 TC 589 (2000). In the Walton case, the balance of any annuity payments due after the grantor’s death had to be paid to the grantor’s estate. The IRS has acquiesced in the Walton case. Notice 2003-72, 2003-44 IRB 964. In addition, the IRS has revised Reg. 25.2702-2(a)(5), Example 5 (held invalid in Walton) to provide that the entire interest qualifies as a retained interest for gift tax calculation purposes. A person and that person’s estate shall be treated as a single qualified recipient.

c. GRATs and GRUTs are only effective to accomplish their intended transfer tax savings if the grantor survives the term of the trust. The GRUT is not generally used as an estate planning technique, since it has the effect of returning more property to the grantor, which is not the goal of planning. The GRAT, with its fixed annuity, is generally used. If the grantor fails to survive the term, then the grantor has retained an interest in the trust property at the time of the grantor's death, and the value of the trust property required to produce the called-for annuity is included in the grantor's estate. Code Section 2036; Reg. 20.2036-1. This suggests that the grantor should be conservative in evaluating his or her life expectancy, or "hedge" by either using a series of trusts of differing terms so that at least some are likely to achieve the desired results, or by purchasing a life insurance policy that will pay off if the grantor dies before the expiration of the trust term.

NOTE: A "successful" GRAT will accomplish all of the business owner's objectives stated above. The business will be moved to younger beneficiaries at a reduced transfer tax cost. The owner may continue to receive an income from the business for some selected period of time. The future appreciation is out of the grantor's estate and inures to the benefit of the remainder beneficiaries so long as the grantor survives the term of the trust. Unlike the private annuity, we are "rooting" for the grantor to live beyond the trust term in the GRAT situation. The grantor can serve as the trustee of the trust and manage the trust property (the business interest) at least for the duration of the grantor's retained interest term and possibly longer.

5. GRATs and GRUTs will qualify as S corporation shareholders provided they are treated as grantor trusts for federal income tax purposes. Code Sections 671 through 679. Interests in family limited partnerships and limited liability companies can also be conveyed to GRATs and GRUTs.

Planning Suggestion: Consider combining the discounting opportunities discussed earlier with the further discounting opportunities of a GRAT. The idea is to transfer a minority interest in an S corporation (or in a family partnership or limited liability company) to a GRAT, taking advantage of the discounts for minority interest and lack of marketability, followed by the actuarial calculation of the GRAT retained and remainder interests. Also, use multiple single property GRATs so that if some properties appreciate while others do not, multiple GRATs allow the appreciation from the successful properties to remain with the beneficiaries, rather than having a net result of little or no appreciation if one or more properties in the GRAT is not successful.

6. **Proposed Anti-GRAT Legislation**

The Administration's 2014budget has proposed limiting the use of GRATs by imposing the following requirements:

1. A minimum 10-year term.

2. A remainder interest that is greater than zero (how much greater is not specified; commentators have suggested 10% is the likely target).

3. No declining annuity during the first 10 years of the GRAT's term.

The fact that these rules were not (and have not yet been) enacted leaves the GRAT "in play", at least until the next round of tax law changes.

D. **Estate Freezes: Installment Sales to Intentionally Defective Grantor Trusts**

This technique combines favorable estate tax planning with advantageous income and gift tax planning. It is designed to allow an income tax-free sale of property with appreciation potential to be made to a trust whose beneficiaries are the heirs of the trust grantor. Properly designed, the appreciation on the property sold to the trust is removed from the trust grantor's estate. (This accomplishes a valuation "freeze").

1. A person (the grantor) creates a trust for the benefit of children or grandchildren, and sells assets to the trust in exchange for a long-term installment note. The sale is made for fair market value, so that the sale by the grantor to the trust is not treated as a gift to the trust beneficiaries. An appropriate market rate of interest is used in connection with the note.

2. The trust is drafted so that the grantor is treated as the owner of the trust for income tax purposes, but not for estate tax purposes. This is accomplished by including certain administrative powers in the trust to be retained by the grantor (such as the power to substitute trust assets of equivalent value in a non-fiduciary capacity, (Rev. Ruls. 2011-28 and 2008-22; PLR 200944002) or the power to borrow trust property without adequate interest or adequate security, etc.) which cause the grantor to be taxed for income tax purposes as the trust owner (Code Sections 671-678) but not to be treated as the trust owner for estate tax purposes (the retained administrative powers, while sufficient to make the grantor taxable on the trust income, fall short of the powers required for inclusion in the

grantor's estate – Code Sections 2036-2038). The trust is thus "defective" because it leaves the grantor subject to income tax, but "intentionally" so, since this was done by design.

3. With the trust so prepared, the sale of assets by the grantor to the trust avoids capital gain taxes, and the note interest to be received by the grantor is not subject to income tax. The transaction is treated as a sale by the grantor to him or herself. Rev. Rul. 85-13, 1985-1 CB 484; PLR 9535026. Appreciation on the assets sold by the grantor to the trust grows outside the grantor's estate. Hence the "freeze" works. If the grantor dies before the note is paid in full, only the unpaid balance of the note is included in the grantor's estate.

4. The only gift tax element of this transaction arises from the requirement that the trust must be capitalized ("seeded") with sufficient assets (other than the promissory note to be received) to establish the independence of the trust from the assets to be sold by the grantor to the trust. The capitalization is generally 10% of the value of the installment note so that there is a debt to equity ratio of not more than 10:1.

5. The IRS has issued Rev. Rul. 2004-64, 2004-2 C.B. 7 which approved several varieties of an intentionally defective grantor trust. The issue in the ruling involved the estate tax consequences to the trust grantor where the trust was either permitted, precluded or obligated to pay the grantor's income tax. Where the trustee was either precluded from paying such tax, or where payments were solely within the discretion of an independent trustee, there were no adverse estate tax consequences to the trust grantor. However, where the trustee is obligated to pay the grantor's income tax liability, such obligation is treated as a retained interest in the trust by the grantor, causing the entire trust property to be included in the grantor's estate at its date of death value. The Ruling also held there was no gift by the grantor to the trust beneficiaries when the grantor paid the trust's income tax. The grantor was satisfying the grantor's own obligation.

6. This transaction is particularly attractive in a family where not all of the family members are involved in the business. It allows the senior family members to use this trust for the benefit of the person(s) who will be the owners of the business, but the note payments (or note receivable) due to the business owner/trust grantor provides an inheritance available for other family members who are not part of the business. In effect, the younger generation family member involved in the business receives the business interest by paying the current fair market value (via the installment note paid for by the operations of the business), with the future appreciation (often arising from the younger person's efforts) neither taxed to the

senior generation nor paid for by the younger generation, nor shared with persons not active in the management of the business. At the same time, should the senior person die with the note paid in full, the value of those payments can be distributed to all heirs, and should the senior person die with a note balance outstanding, the note can be allocated among all beneficiaries.

7. A defective trust can be funded with S corporation shares, since a grantor trust is a permitted S corporation shareholder without being required to meet the additional qualifications of a Qualified Subchapter S Trust (QSST) or an Electing Small Business Trust (ESBT).

8. Consider using a defective grantor trust with grandchildren (skip persons) as the trust beneficiaries. As property is transferred to a defective grantor trust, any applicable generation-skipping transfer tax (GST) exemption (for property gifted to the trust) may be immediately allocated by the grantor, before appreciation in the trust assets has taken place.

9. The 2014 Obama Administration budget suggests that if a taxpayer creates an IDGT and sells assets to the trust, the portion of the trust attributable to assets sold to the trust (including all retained income, appreciation and reinvestments of property) less the consideration received by the taxpayer, will be included in the taxpayer's estate. If the trust ceases to be a grantor trust while the grantor is alive, that amount at that time would be a gift. Distributions to other persons in excess of the prior taxable gift would be a further gift. Any transfer tax due would be payable from the trust property, not from the grantor.

E. <u>The Charitable Bail-Out: Transfer the Family Business Interest and Receive a Tax Deduction</u>

If the business owner wishes to benefit charity, reduces his or her estate, increase cash flow and transfer control of the business to the owner's children with little or no transfer tax cost, this technique can allow these goals to be realized.

1. In its most straightforward form, the first step in a charitable bail-out transaction involves the business owner contributing some or all of his or her ownership interest in the company to a qualified charitable organization as defined in Code Sections 170(c), 2522(a) and 2055(a).

   a. If this gift is made during the lifetime of the business owner, the owner is entitled to an income tax charitable contribution deduction based on the fair market value of the contributed property. The use of the deduction by the owner in the year of the gift is subject to various percentage limitations, reflecting the adjusted gross income of the owner, the character of the transferred property, and the nature of the charitable organization, with any excess deduction eligible for a five year carryforward. (Code Section 170(b))

b. This is preferable to having the business owner simply redeem some of the owner's own shares in the business for cash, and contribute the cash to charity. Here, the redemption transaction would be treated as a dividend, taxable to the owner as ordinary income. (Code Section 301) The net after tax transfer of the balance of the cash would then yield a smaller income tax deduction for the owner.

2. The owner, however, does not want the charitable organization to exercise any control or influence over the business, so the owner may be reluctant to donate the actual stock.

3. Similarly, the charitable organization is generally not eager to hold stock in a closely-held business, since the charity may have little or no expertise in understanding how the business works, and does not wish to hold stock in a business which produces little or no dividend income and for which there is no readily available market.

4. The owner's caution about transferring stock and the charity's lack of enthusiasm for holding the stock lead to the second step in the charitable bail-out transaction–the redemption of the stock from the charity by the corporation.

   a. Cash moves from the corporation to the charity and the stock returns to the corporation.

   b. No capital gain tax is paid by virtue of any appreciation in the value of the stock, since the charity is the seller of the stock in conjunction with the redemption transaction, and the charity is not taxable on gains from the sale of appreciated property.

5. Where the owner's goals were not limited to making a tax deductible charitable gift and having the appreciation in the business interest escape capital gains tax, but also included a transfer of a tax-free controlling interest in the business to children, this can also be accomplished, as follows:

   a. If the children owned some interest in the business (assume shares of stock) prior to the gift of the owner's shares to charity (careful of a possible step transaction issue here) the return of the shares to the business via the redemption leaves the children owning the only outstanding shares in the company.

b. Consequently, the children's interests in the business are increased proportionately, and a portion of the owner's interest in the business has been passed to the children free of any gift or estate taxes.

Example: Assume the children own 40% of the corporation as the result of a longstanding pattern of annual gifts to them (or purchases by them). The owner then transfers the owner's remaining corporate shares (the other 60%) to a charity, which shares are eventually acquired by the corporation in a redemption transaction. The children's interest now represents 100% of the outstanding stock of the corporation.

6. The Internal Revenue Service will attack a charitable bail-out transaction if it can show that there was a prearranged legally binding obligation that gave the business the right to compel the charity to surrender the shares for redemption. Rev. Rul. 78-197, 1978-1 C.B. 83, PLRs 199919039, 9029021, 8639046, 8623007, 8411029. If the Service can prevail on this theory, the transaction will be recharacterized as a redemption by the company from the business owner. In that event, the owner will be taxed as if he or she received a taxable dividend from the company, and then made a contribution of the proceeds to charity. Blake v. Commissioner, 697 F. 2d 473 (2nd Cir. 1982).

7. This contention can be overcome so long as it can be shown that the charitable organization was not legally obligated to sell the stock to the corporation or provide special value (as in Blake, above) to the donor. A gift of stock to the charity followed by a previously discussed and even arranged redemption is permissible, so long as the charity is under no binding legal obligation to submit the stock to the corporation for redemption. Palmer v. Commissioner, 62 TC 684, aff'd 523 F.2d 1308 (8th Cir. 1975); Grove v. Commissioner, 490 F. 2d 241 (2nd Cir. 1973); Caruth v. Commissioner, 865 F. 2d 644 (5th Cir. 1989); Carrington v. Commissioner, 467 F.2d 704 (5th Cir. 1973); Rev. Rul. 78-197, 1978-1 CB 83; PLR 9611047.

F. Family Partnerships and LLCs as Family Transfer Vehicles

1. Perhaps no area of intrafamily transfers has seen as much litigation as transfers involving the creation of family limited partnerships and LLCs. There have been numerous cases addressing this planning technique, each turning on the particular fact-sensitive pattern involved.

2. The "easy" cases for the government to win are those involving deathbed transfers, those where despite conveyance of assets to a partnership the decedent continued to use or have access to virtually all of the transferred assets and those involving transfer of personal assets (such as a personal residence) that the decedent continued to use and occupy. The government argues a retained interest in the income from or the use of property under Code Section 2036 in these cases to require inclusion of the "transferred" property in the decedent's estate.

3. There have been taxpayer victories. Many cases address the "bona fide sale exception". If the taxpayer can show a significant non-tax business purpose for transferring assets, the taxpayer has a reasonable chance to prevail.

4. Courts now use the standard for the bona fide sale exception to Code Section 2036 for FLPs that was announced in Bongard v. Commissioner — there must be a legitimate and significant nontax reason for the partnership. If the planner wishes to avoid Section 2036 with respect to assets contributed to an FLP, see if one of the following special circumstances might apply to the specific facts of the family situation. These are the special situations that have been recognized by cases as meeting the "legitimate and significant nontax reasons" test.

   - Large block of voting stock in closely held corporation, Black v. Commissioner.

   - Joint management and keeping a single pool of assets for investment opportunities, patent royalties and related investments, Mirowski v. Commissioner.

   - Closely held business; resolution of family litigation regarding active management of closely held business, Stone v. Commissioner.

   - Maintaining a single pool of investment assets, providing for management succession, and providing active management of oil and gas working interests, Kimbell v. United States.

   - Perpetuating buy-and-hold investment philosophy for du Pont stock, Schutt v. Commissioner.

   - Preserve family ranching enterprise, consolidate undivided ranch interests, Church v. United States.

- Placing ownership of closely held company in a single entity for purposes of shopping the company by a single seller rather than by multiple trusts, Bongard v. Commissioner.

- Continue investment philosophy and special stock charting methodology, Miller v. Commissioner.

- Protect family assets from depletion in divorces, Keller v. United States.

- Centralized management and prevent dissipation of family "legacy assets," Murphy v. Commissioner.

- Asset protection and management of timberland following gifts of undivided interests, Shurtz v. Commissioner.

- Managing woodland parcels as a family asset for later development and sales of lakeside homes, Stone v. Commissioner, TC Memo 2012-48.

- Ensuring equal distribution of estate among children thereby avoiding litigation, effective management and minimizing potential liability for operation of quarries and other real estate properties requiring active management, Estate of Kelly v. Commissioner.

5. The recent case of Estate of Kelly, T.C. Memo 2012-73 (March 19, 2012) involved gifts of family limited partnership interests. The IRS argued that "the parties had an implied agreement that decedent would continue to enjoy the income from the family limited partnerships." The court determined that there was no implied agreement of retained enjoyment under Section 2036(a)(1). No other reported case has determined that facts that might suggest an implied agreement of retained enjoyment were not sufficient to invoke Section 2036(a)(1). The parties respected the various entities, observed formalities, and took reasonable steps each step of the way in doing so. The children carefully respected the management responsibility of the corporate general partner by providing their services as employees of the corporation and taking reasonable steps to determine an appropriate management fee to be paid to the corporation and to determine their respective salaries based on the services that they performed for the corporation.

G. Multi - Generation-Skipping Transfer Tax Planning: Using Dynasty Trusts

1. The GST tax exemption may be used affirmatively to create a Dynasty

Trust.

2. In general description, a Dynasty Trust provides for life estates in property for every generation of beneficiaries. While the trustee is given the power to distribute trust principal, such distributions are discouraged.

3. A Dynasty Trust is typically structured to last for the maximum period of time permitted by state law (i.e. the time period allowed by the rule against perpetuities). In some states the maximum duration of a trust is lives in being on the date of the creation of the trust plus 21 years. Other states have abolished the rule against perpetuities and provide that the trust may exist forever. Obviously, those states allowing the longest duration of the trust are the favored jurisdictions.

4. If a Dynasty Trust is created in a state that has abolished the rule against perpetuities, and funded with an amount equal to the maximum available GST tax exemption of the transferor, the trust property will not be subjected to any further estate, gift or GST tax liabilities (assuming the trust principal is not distributed to the beneficiaries).

5. If an annual rate of growth of 7.2% is assumed for the trust principal, it will double in value every ten years. Hence, the "Dynasty" is created by a transferor using his or her GST tax exemption for generations yet unborn.

6. Ideally, any use of GST tax exemption should be leveraged by funding a generation-skipping transfer with property likely to appreciate in value over time. A lifetime gift might ideally address this suggestion. Given the $5,250,000 lifetime gift tax exemption available in 2013, this may be an ideal time to consider the Dynasty Trust planning opportunity.

7. The Dynasty Trust offers the additional attraction of asset protection for future generations, since no beneficiary of the trust is the "owner" of any of the trust assets, so that creditors of beneficiaries will be unable to reach such assets.

8. <u>Caution:</u> The Obama Administration 2014 budget proposes a maximum 90 year duration for a trust, after which time it would be subjected to transfer tax.

PART III. <u>ENTER INTO A BUY-SELL AGREEMENT</u>

<u>Considerations for Buyers and Sellers in Buy-Sell Agreements for Closely-Held Businesses</u>

A. **<u>Definition</u>**

A buy-sell agreement is an agreement between the owners of a business, or among the owners of the business and the entity, to purchase and sell interests of the business at a price set under the agreement upon the occurrence of certain future events. The events may include death, disability, retirement, an offer to purchase an owner's interest from an outside party, and termination of employment.

B. **<u>Objectives of a Buy-Sell Agreement</u>**

1. **<u>For the Entity</u>**

a. Restrict the sale or transfer of an ownership interest to unwanted third parties and avoid disputes among owners.

b. Void transfers to individuals or entities that would terminate an S election or the status of the corporation as a professional corporation under state law.

c. Enable a smooth transition in the control and/or ownership of the entity.

d. Provide a method of funding the buy-out of a withdrawing, divorcing or deceased owner's interest and establish the terms for payment of the purchase price.

2. **<u>For the Deceased Owner's Estate</u>**

a. Enable the estate to obtain a favorable price for what could have been an unmarketable asset.

b. Ensure that the estate receives cash for payment of estate taxes and administration expenses.

c. The estate will not be forced to negotiate price and terms from a weak bargaining position.

d. Establish the value of the ownership interest for federal estate tax purposes.

e. Relieve the estate, heirs or beneficiaries from involvement in the affairs of the business.

f. Provide a source of income to the spouse and other heirs or beneficiaries.

3. **<u>For the Retired or Disabled Owner</u>**

a. Gives the retired or disabled owner a source of cash, either in a lump sum or over a period of time, usually with favorable capital gain treatment.

b. Eliminates the potential for conflict between the disabled or retired owner and remaining owners over policies of the entity concerning cash distributions, dividends, salary and growth.

4. **For the Remaining Owners**

a. Enables the remaining owners to be certain of the terms under which a departing owner's interest will be purchased.

b. Provides a source of long-term financing for the purchase of a departing owner's interest, allowing payments to be made out of the business' cash flow.

c. Avoids the moral dilemma that could arise in negotiating price and terms with the spouse and children of the deceased or incapacitated owner (often a long-time friend, partner or business associate).

C. **Types of Buy-Sell Agreements**

1. **Cross-Purchase**. A cross-purchase agreement, also referred to as a shareholders' or partners' agreement, requires, or permits, the remaining owners to purchase on a pro rata or other basis the ownership interest of a withdrawing or deceased owner.

2. **Entity Buy-Out**. Under a redemption agreement or an entity purchase agreement, the entity is obligated or has an option to purchase the ownership interest of the withdrawing or deceased owner.

3. **Hybrid Agreement**. Under a hybrid or combination agreement, the entity has either an option or an obligation to purchase the ownership interest of the withdrawing or deceased owner, but the entity is permitted to assign its right to purchase the interest to the remaining owners.

D. **Choosing the Right Type of Agreement**

1. **Number of Owners**

If life insurance will be used to finance the purchase of the interest of a deceased owner, a large number of owners may make the use of a cross-purchase agreement cumbersome because each owner will be required to purchase a policy on the life of each of the other owners. When there are a large number of owners and a cross-purchase agreement is desired, a trust or partnership may be used to own the life insurance policies needed to carry out the purchase. This will reduce the number of policies required to cover all of the business owners.

2. **Premium Payments on Life Insurance Policies**

   a. The premium payments, whether made by the entity or the owners, are not deductible.

   b. Note that if the owners are not the same age or insurable at the same rate, or do not own the same percentage of interest, there may be perceived inequities depending upon whether the entity or the owners pay the premiums. If the entity is paying the premiums, the majority or older owner may be funding his or her own purchase. If the owners are paying the premiums, a younger or minority owner may be paying a higher premium than an older or majority owner.

3. **Transfer for Value Problems**

   a. Generally, life insurance proceeds are not subject to income tax unless the policy has been transferred to another person for valuable consideration (the "transfer for value rule"). Code Section 101(a)(1).

   b. Such a transfer for value would subject the proceeds payable on the death of the insured to income tax to the extent they exceeded the purchase price of the policy and premiums paid after the transfer.

   c. The transfer for value rule does not apply to a transfer to the insured, a partner of the insured, a partnership in which the insured is a partner, or a corporation in which the insured is an officer or shareholder. Code Section 101(a)(2). A sale of a life insurance policy to a grantor trust is treated as a sale to the insured; therefore within the exception to the transfer for value rule. Rev. Rul. 2007-13, 2007-11 I.R.B. 684.

   d. In the case of a corporate cross-purchase agreement, when one of the shareholders dies, the policies he or she owns on the lives of the other shareholders cannot be sold by his or her estate to any remaining shareholder except the insured (or the corporation) without triggering the transfer for value rule.

   e. A partnership among the shareholders will avoid the transfer for value problem PLR 9012063, PLR 9045004, PLR 9042023.

f. The Tax Court has held that the partnership to which a policy held by a corporation is transferred must actually operate as a partnership and may not be a partnership in form only. Swanson, Jr. v. Commissioner, 518 F. 2d 59 (8th Cir. 1975).

g. The IRS has adopted a "no ruling" policy on this issue. Rev. Proc. 97-3, I.R.B. 1997-1, Sec. 5.05.

4. **Alternative Minimum Tax Problems**

a. The corporate alternative minimum tax may apply to 75% of the proceeds of a life insurance policy paid to a C corporation.

b. A small business corporation having average gross receipts of less than $7.5 million for a three-year period will not trigger this corporate AMT rule.

c. Using an S corporation, partnership or limited liability company avoids this problem, since the shareholders, partners, or members are subject to the individual alternative minimum tax, which does not include "adjusted current earnings" as a tax preference item.

5. **Accumulated Earnings Tax**

a. A C corporation may have accumulated earnings tax consequences if it sets aside liquid assets to fund the purchase of shares under a buy-sell agreement. The accumulated earnings tax is equal to 20% of the accumulated taxable income of a C corporation. Code Section 531.

b. Accumulating funds for the buy-out of a minority shareholder may be considered a reasonable need of the corporation. Compare *Dickman Lumber Co. v. Commissioner*, 355 F. 2d 670 (9th Cir 1966) with *Mountain States Steel Foundries, Inc. v. Commissioner*, 284 F. 2d 737 (4th Cir. 1960).

6. **Basis for Income Tax Purposes**

a. Under a redemption agreement for a C corporation, the basis of the shares owned by the remaining shareholders is not increased as a result of the corporation's purchase of the shares of the withdrawing or deceased shareholder.

b. Conversely, under a cross-purchase agreement, each remaining shareholder obtains a basis in the newly-purchased shares equal to the purchase price he or she pays.

E. **Suggested Terms of a Buy-Sell Agreement**

1. **Triggering Events**

a. The events triggering a purchase may include the death, retirement or disability of an owner, an attempted sale to a third party, and the termination of employment of an owner for reasons other than death, retirement or disability. Such termination may be voluntary or involuntary.

b. Divorce, bankruptcy or insolvency of an owner may also trigger an option or obligation to purchase, often to avoid participation by the divorced spouse or the bankruptcy trustee in the entity's management.

2. **Setting the Purchase Price**

a. One of the most important features of the buy-sell agreement should be the mechanism for determining the purchase price of the ownership interest. In many cases, it will be necessary to use the services of a certified public accountant or a professional business appraiser.

b. One of the simplest methods to use in setting the purchase price is to use a fixed price, which is redetermined periodically by the owners, who could agree to meet each year after the financial statements for the entity have been prepared to discuss adjusting the purchase price for purposes of the agreement. Consider having a different purchase price for different events, i.e. while a full price may be paid in the event of death, disability or normal retirement, perhaps a lower price should be paid for early "walkout" or termination for cause.

c. The book value of a business is often used in buy-sell agreements, but this is not a good idea. In most cases, the book value will not reflect the real value of the business since the book value uses the historic cost of assets less depreciation. The IRS is very likely to reject a buy-sell agreement based on book value. Estate of True, Jr. v. Commissioner, 390 F. 3d 1210 (10th Cir. 2004). An adjusted book value may be a more appropriate measure of valuation because it can take into account factors such as: Good will and work in progress; Any accrued income or expenses not appearing on a balance sheet; Any contingent liabilities; The appraised value of certain assets such as real estate and large machinery; Insurance proceeds (either cash value, excess of premiums paid over cash value, or as proceeds).

d. The agreement may require that an appraisal be made at the time the interest of the withdrawing or deceased owner is to be purchased. Sometimes specific instructions will be given on what factors should be considered and the relative weight to be given to such factors. This method assumes a valuation proximate to the time of purchase, but also creates uncertainty until that time. Selection of the appraiser is another issue to consider. How should it be addressed in the buy-sell agreement? Many buy-sell agreements provide that the entity or remaining owners will choose and pay for the initial appraiser. If this is not the case, the two appraisers choose a third appraiser, whose expense is split evenly, and whose appraisal becomes binding.

e. Yet another method bases the purchase price on the estate tax value of the deceased owner's interest. However, such a method will not provide any certainty to the owners as to the purchase price until the death of one of them, and will not provide a price for purposes other than a purchase at death.

f. There is a long history of controversy between taxpayers and the IRS over the issue of buy-sell agreements in general, and those involving family business interests in particular. Code Section 2703 was enacted in 1990 to deal specifically with valuations in buy-sell agreements. The general rule of Section 2703 is that for estate, gift and generation-skipping transfer tax purposes, the value of any property is determined without regard to any right or restriction relating to the property. Code Section 2703(a); Reg. 25.2703-1(a).

    i. There are exceptions to the general rule which provide that a right or restriction will not be disregarded (and therefore allowed as a factor in valuing the transferred property) if it satisfies each of the three following requirements:

        a. The right or restriction is a bona fide business arrangement. Code Section 2703(b)(1);

        b. The right or restriction is not a device to transfer the property to members of the decedent's family or to objects of the transferor's bounty for less than full and adequate consideration in money or money's worth. Code Section 2703(b)(2); Reg. 25.2703-1(b)(1)(ii).

c. The terms of the right or restriction are comparable to similar arrangements entered into by persons in an arms'-length transaction at the time the right or restriction is created. Code Section 2703(b)(3); Reg. 25.2703-1(b)(1)(iii).

ii. A "safe harbor" is created by the regulations in that a right or restriction is considered to meet each of the three requirements if more than 50% by value of the property subject to the right or restriction is owned directly or indirectly by individuals who are not members of the transferor's family.

iii. It is difficult, but not impossible, to fit a family buy-sell agreement within the requirements of Section 2703. The IRS typically opposes transfer restrictions in family business agreements that have the effect of reducing the value of the business interest. <u>Holman v. Commissioner</u>, 130 T.C. No. 12 (2008); aff'd 105 AFTR2d para. 2010-721 (8th Cir. 2010); Smith III v. United States, 94 AFTR2d 2004-5283 (W.D. Pa 2004). <u>Amlie v. Commissioner</u>, T.C. Memo 2006-76.

3. **<u>Payment Terms</u>**

a. The buy-sell agreement should specify how the purchase price will be paid. Most buy-sell agreements will permit a portion of the purchase price to be paid in installments. Where life insurance is present, the full amount of the proceeds are generally paid to the decedent's estate.

i. If the installments are payable over an extended term, the purchase may be funded out of the entity's or remaining owners' cash flow. Consequently, the need for life or disability insurance funding will be reduced.

ii. In the case of a corporation, the note would usually be secured by a pledge of the shares held by the other shareholders.

b. The purchase price also may be paid over a period of time based on the profitability of the entity, so that the more profits the entity had in a given year, the more it would pay on the outstanding balance. However, the price itself would not be dependent upon the profits, only the period over which the purchase price would be paid.

4. **<u>Should the Buy-Sell Be Mandatory or Optional?</u>**

   a. A decision should be made whether the purchase or sale will be mandatory, or whether the entity or remaining owners will only have an option or right of first refusal. In most cases, the withdrawing owner or deceased owner's estate should be obligated to sell if one of the goals of the buy-sell agreement is to limit owners to persons active in the business. Similarly, the entity or remaining owners should be obligated to purchase the interest. It is unlikely that the withdrawing owner or deceased owner's estate will find a ready market for a minority interest in a closely-held business.

   b. The estate tax consequences to the deceased owner's estate must be considered if the entity or other owners have only a right of first refusal and the price at which the interest will be purchased is to be the higher of the price established under the agreement or the price contained in a good-faith offer of a third party.

5. **<u>Restrictions</u>**

   a. The agreement usually should contain restrictions on voluntary transfers of interests in the business.

   b. Transfers may be permitted to the owner's spouse or children, or to trusts created for their benefit, in order to allow the owners to engage in estate planning transactions. Restrictions must also apply to the transferees.

   c. Transfers to third parties may be permitted after first offering the interest to the entity or the other owners, either at the price determined under the agreement or at the lower of the price determined under the agreement or the price offered by a third party.

<u>PART IV – SELL THE BUSINESS TO THIRD PARTIES</u>

I. <u>The Scope of the Task</u>

A. Legal and Tax Issues

1. Any person considering buying or selling a business is faced with a myriad of issues well beyond the simple questions of "How Much Must I Pay?" and "How Much Will I Get?" A business interest consists of assets, liabilities, employees, contracts, shareholders and various rights and obligations. The interests of buyers and sellers in these various components are often not in harmony. Moreover, federal and state laws have arisen that impose requirements on sellers of business interests designed to protect employees, shareholders and the public interest. Compliance with these laws is central to any business acquisition.

2. Tax considerations are also central to the purchase and sale of a business. The seller looks to minimize taxes and tries to have any required tax liability imposed at the favorable capital gain rates. The buyer wants to write off the cost of the acquisition as quickly as possible, through ordinary business expense or depreciation deductions. The tax laws themselves offer a variety of options that range from acquisitions that are tax-free to tax-deferred to fully taxable. The tax considerations force buyers and sellers to make particular choices that will strongly influence the structure of their deal.

B. The Form of the Transaction

1. While the principals may be focusing on the "substance" of the deal, someone, often the professional advisors, must force a focus on the "form" of the deal, as well. There are significant differences from both a liability and tax standpoint on whether the deal is structured as the sale of the seller's stock or the sale of the seller's assets.

2. As a general rule, sellers prefer to sell stock, while buyers prefer to acquire assets. Where the deal is a stock transaction, the seller may expect a single imposition of capital gain taxation, with the buyer assuming all of the seller's outstanding liabilities. Where the deal is an asset transaction, the buyer expects to obtain a higher cost basis in the acquired assets, higher depreciation availability and freedom from the seller's liabilities. The seller in an asset sale is likely to incur some ordinary income tax from inventory sales and/or depreciation recapture, and, if a C corporation, may be subjected to two levels of taxation– at the corporate level and again upon distribution of sale proceeds to the shareholders.

3. The point to be made here is that the parties must realize that the form they select will have an effect on the net amount they will realize from the transaction. The form will also dictate which of the parties will have

ongoing responsibility for items such as product liability issues and third party claims. Discussions of the purchase price should take into account the structure of the transaction, and should focus very carefully on the after tax price, and not solely on the before tax price.

C. Tax Classifications of Business Acquisitions

1. Taxable Asset Acquisitions– Basic Rules

a. An asset sale will create a single level of tax to a seller that is an individual, a sole proprietorship, or a pass-through entity such as a partnership or limited liability company. If the seller is a C corporation, there will be immediate tax liability at the corporate level, and also a likely additional level of tax at the shareholder level when the selling corporation is liquidated and the proceeds of the asset sale distributed to the shareholders. Where the seller is an S corporation, there is usually one level of tax to the shareholder, but there also may be a corporate level tax if the built-in gain rules of Code Section 1374 apply (the built-in gain tax may apply where the sale occurs within 10 years (or 7 years for 2010 and 5 years for 2011 through 2013) of a former C corporation's election of/conversion to S corporation status).

b. The buyer of assets receives a cost basis in the assets acquired. The buyer does not, however, receive any of the tax attributes of the selling corporation. These attributes are lost if the selling corporation is liquidated, or remain with the selling corporation if there is no liquidation.

c. In order to avoid the double tax problem of the C corporation, consideration may be given to refraining from liquidating the corporation and distributing the cash to the shareholders (the event that gives rise to the second level of tax) and continuing the corporation's existence. The C corporation typically has cash as the result of the sale of its assets. Failure to distribute the cash in liquidation could cause the ongoing C corporation to incur liability for the accumulated earnings tax, the personal holding company tax, and the corporate alternative minimum tax. These taxes may prove to be even more burdensome than the double tax of the liquidation distribution.

d. Is the solution here to have the C corporation now elect S corporation status? Probably not. If an S corporation has C corporation earnings and profits, and if more than 25% of the S corporation's gross receipts for a tax year constitute "passive investment income" [Code Section 1362(d)(3)] the S corporation will be subject to a special tax liability under Code Section 1375, and will lose its S corporation status after three consecutive years of having this level of passive investment income. Note: Gains from sales or exchanges of stock and securities are no longer considered "passive income" for purposes of this rule. Code Section 1362(d)(3)(B) and (C), effective for tax years beginning after May 25, 2007. [Small Business and Work Opportunity Act of 2007].

2. **Taxable Stock Acquisitions– Basic Rules**

a. In a taxable stock acquisition, the selling shareholder(s) will realize a single level of gain or loss, (presumably capital gain or loss) regardless of whether the corporation is a C or S corporation.

b. The buyer in a taxable stock acquisition acquires a cost basis in the acquired stock. However, the acquired corporation is not affected by the stock acquisition. This means that the corporation's basis in its own assets and its tax attributes (i.e. operating or capital losses, deductions, credits, carryovers) are not affected by the sale. As will be discussed below, the buyer may face certain restrictions on using the acquired tax attributes.

c. Since the acquired corporation does not recognize gain or loss on the stock sale, the inherent gain in the corporation's assets remains to be taxed to the buyer. It may be possible, for tax purposes, to treat a stock acquisition as an asset acquisition by making a Section 338 election.

D. Taxable Asset Acquisitions: Allocation of the Purchase Price Among the Acquired Assets.

1. As a basic general rule of taxation, when a buyer acquires a group of assets in a single transaction, it is required that the purchase price be allocated among the acquired assets. Williams v. McGowan, 152 F. 2d 570 (2nd Cir. 1945).

2. Assets acquired in a business transaction typically include inventory, land, depreciable property (such as machinery, equipment and buildings), intangible property (such as copyrights, patents, trademarks, licenses and software) and goodwill, customer lists, or going-concern value.

3. The Omnibus Budget Reconciliation Act of 1993 reduced the importance from the buyer's viewpoint of allocating the purchase price away from intangibles, notably goodwill and going-concern value, by permitting the amortization of such purchased intangibles ratably over a fifteen year period. Code Section 197; see also <u>Newark Morning Ledger Co. v. United States</u>, 507 US 546 (1993).

   a. Section 197 intangibles include: goodwill; going concern value; information-based assets, such as know how, customer lists, workforce in place, accounting systems, supplier lists, etc.; any government granted rights, licenses or permits; covenants not to compete entered into in connection with the acquisition of any interest in a trade or business; and any franchise, trademark or trade name. Code Section 197(d); Reg. 1.197-2(b).

   b. Certain types of property are specifically excluded from the definition of a Section 197 intangible, including: interests in land; interests in corporations, partnerships, trusts and estates; interests in futures contracts or other financial contracts; certain computer software; interests under tangible property leases; interests under certain existing debt; sports franchises and related items; and certain transaction costs. Code Section 197(e); Reg. 1.197-2(c).

   c. Section 197 applies only to purchased intangibles, and not to taxpayer-created intangibles, even if the value of the self-created intangibles can be estimated.

   d. A Section 197 intangible must be amortized ratably over the fifteen year period beginning in the month in which the intangible is acquired. No other depreciation or amortization is permitted with respect to a Section 197 intangible.

E. <u>Code Section 1060: Specific Rules for Allocation of the Purchase Price - Taxable Asset Acquisitions.</u>

1. Code Section 1060 applies to what are referred to as "applicable asset acquisitions." These are defined to include all <u>taxable</u> acquisitions of a trade or business, including deemed asset sales under Code Section 338. Nontaxable asset acquisitions are not within this definition, since the buyer's basis in the assets acquired in such transactions is determined by reference to the target corporation's basis in such assets. The allocation rules of Code Section 1060 are binding for purposes of determining both

the character of the gain or loss of the seller and the buyer's basis in the acquired assets.

2. Code Section 1060 adopts the "residual" method of allocation, whereby the purchase price is allocated in accordance with a specified system of priorities, first to identifiable tangible and intangible assets acquired, up to the amount of the fair market value of such assets. Any remaining consideration (the residual amount) is then allocated to goodwill.

3. The residual method's system of priorities creates seven categories of asset classes. The allocation of the purchase price is performed by first allocating the amount to Class I assets, up to the fair market value of such Class I assets, if any. Any amount of the purchase price remaining after the Class I allocation is then allocated to Class II, and so on through Class VI assets. Any remaining amount of the purchase price is finally allocated to Class VII.

4. The seven asset classes (Reg. 1.1060-1 cross referencing Reg. 1.338-6(b)) may be described as follows:

    a. Class I: Cash and cash equivalents, including general deposit accounts (but not certificates of deposit) held in banks and other depository institutions.

    b. Class II: Certificates of deposit, government securities, marketable stock and securities, foreign currency and similar actively traded personal property.

    c. Class III: Accounts receivable, mortgages, credit card receivables and debt instruments (but not those that are contingent or that were issued by related persons).

    d. Class IV: Inventory and dealer real property, including property held primarily for sale to customers in the ordinary course of business.

    e. Class V: Identifiable tangible or intangible assets not otherwise included in any of the other six asset classes. This would include items such as land, buildings, machinery used by the taxpayer in the manufacture of goods and stock owned in closely-held corporations.

    f. Class VI: All Section 197 intangibles other than goodwill and going concern value (including covenants not to compete, regardless of their duration).

g. Class VII: Goodwill and going concern value, regardless of whether they qualify as a Section 197 intangible.

5. Allocations to the first six classes are limited to the fair market value of such assets. There is no limit on the amount that may be allocated to Class VII, which is the residual category. For purposes of depreciation, the basis of an asset involved in a transaction to which Code Section 1060 applies may not exceed the consideration allocated to that asset. Reg. 1.167(a)-5T.

6. The rules of Code Section 1060 still leave a great deal of room for disputing purchase price allocations with the Internal Revenue Service. Corporate sellers may be opposed to purchase price allocations among individual assets generating ordinary income vs. those that will generate capital gain. C corporation owners will be concerned with double tax issues. Buyers will seek rapid tax write-off of the acquired assets. There is still a significant disparity between the recovery periods of many assets, including purchased intangibles. For example, equipment costs may generally be recovered over 7 years, while nonresidential real estate must be recovered over 39 years. Buyers acquiring the assets of a business will now favor an allocation to goodwill (with its 15 year rate of recovery) rather than to nonresidential real property.

7. While the assets placed in Classes I, II, and III should lend themselves to valuation without controversy, the residual method of allocation places a substantial premium on valuing Class IV and V assets. This is where the "action" is for the buyer. Cost recovery and amortization deductions can reduce the effective cost of acquisition. Allocation to categories and classes more favorable than not can make a difference. For example, if the buyer requires the seller to accept a covenant not to compete for three years, the purchased covenant is a Class VI asset. Although it will be paid out over three years, it must be amortized over 15 years. Could the buyer and seller reach the same economic result for the seller by reducing the amount of the covenant and paying the seller consulting fees which may be deductible as an ordinary business expense as paid, rather than over a 15 year amortization period?

8. When a transfer of assets constitutes an applicable asset acquisition, both the buyer and the seller must complete Form 8594, "Asset Acquisition Statement Under Section 1060" and attach the form to each of their respective tax returns for the year of the applicable asset acquisition. While a written agreement with respect to the allocation of consideration

in an acquisition is binding on both parties, it is not binding on the Internal Revenue Service which has the discretion to independently determine what it believes to be a proper allocation. Form 8594 does not require a showing of the individual asset-by-asset allocation of consideration. Instead, the consideration is allocated among the broad asset classes.

Part V: Special Considerations Involving S Corporation Acquisitions

A. **Eligibility Issues**

1. Keep in mind that an S corporation may only have 100 shareholders. If an acquisition will result in there being more than 100 shareholders of an S corporation, the S election will terminate. Code Section 1361(a)(1).

2. The S corporation rules also contain limitations on permitted shareholders. Individuals (but not nonresident aliens) can be S corporation shareholders, as can estates (for a reasonable period of administration) certain trusts (QSSTs, ESBTs, electing trusts under Code Section 645 and grantor trusts) and certain types of corporations. A C corporation may not be a shareholder of an S corporation. An S corporation may own 100 percent of a Qualified Subchapter S Subsidiary (QSSS). Where this is the case, the parent S corporation reports the S corporation subsidiary's operations as if it were a division of the parent. An S corporation may also own 80 percent or more of the stock of a C corporation, so long as the S corporation is not a participant in the filing of a consolidated return with the C corporation subsidiary.

3. Another S corporation requirement is that the S corporation has only a single class of stock. Voting and nonvoting stock are not considered separate classes of stock so long as their rights and preferences (dividends, liquidation, etc.) are all identical with the exception of the right to vote. Preferred stock is not allowed in an S corporation. IRC 1361(c)(4).

B. **Debt vs. Equity Issues**

1. When debt is involved in an acquisition involving an S corporation, concern must be raised that the debt will not be reclassified as an equity interest and lead to a violation of the single class of stock requirement.

2. Code Section 1361(c)(5) provides a safe harbor for "straight debt." The existence of straight debt in an acquisition involving an S corporation will not be treated as a second class of stock. Straight debt means debt that is not convertible into

stock, that may not provide for interest contingent on profits or the borrower's discretion and that is issued by either a creditor who would qualify as an S corporation shareholder or that is a creditor actively and regularly engaged in the business of lending money. Debt that creates preferential rights to cash flow would be a problem.

C. **Built-In Gains Tax Issues**

1. Code Section 1374 imposes a tax on any "built-in gains" realized by an S corporation. This provision is designed to prevent a C corporation from becoming an S corporation and then selling its assets to avoid the two levels of taxation inherent in C corporation rules. When an existing C corporation elects to become an S corporation, the built-in gains tax will apply to all recognized built-in gains that arise from sales and exchanges of former C corporation assets during the 10 year period commencing with the date of the S election. Where applicable, the tax is imposed at the maximum rate charged under Code Section 11(b). Code Section 1374(a) and (b). **Important:** For tax years 2009 and 2010, the built-in gains tax was not applicable where the 7th year in the ten-year recognition period precedes that year. The look back period for 2011-2013 is five years. It returns to ten years for 2014, absent further legislation.

2. Where built-in gains are required to be recognized by an S corporation, the corporation may use NOLs acquired from a C corporation in a tax-free acquisition to offset such gains, provided the rules of Code Sections 381 through 384, discussed above, are satisfied. Code Section 1374(d).

3. While an S election is in effect, an S corporation may not use any C corporation attributes, except to offset built-in gain income. Code Section 1371(b)(1).

Part VI: Special Considerations Involving Acquisitions of Partnership Interests

A. **General Rules– Capital Gain and Ordinary Income Issues**

1. As a general rule, the sale of a partnership interest (or an interest in a limited liability company, since it is taxed as a partnership) represents the sale of a capital asset, allowing the selling partner to recognize gain or loss from a sale or exchange. Code Sections 741, 1001.

2. However, Code Section 741 also provides that the capital asset treatment will not apply to the extent the sale proceeds are attributable to "Section 751 assets" of the partnership.

3. The purpose of Code Section 751 is to make certain that each partner reports his or her share of ordinary income inherent in certain partnership assets. Section 751 assets include the following broad categories:

   a. Inventory. This includes any property held by the partnership that would be classified either as inventory or as property held primarily for sale to the customers of the partnership in the ordinary course of its business.

   b. Unrealized Receivables. This includes any right to payments that would constitute ordinary income to the partnership. Included in this rather broad category are payments for services, payments for goods that are not classified as capital assets, and the sale of assets that would generate ordinary income from recapture.

4. When a partnership interest is sold, the selling price is allocated among the partnership assets as divided into Section 751 assets and non-Section 751 assets based upon the relative fair market values of each category.

5. When a partnership interest is sold or exchanged and Section 751 applies, the selling partner must file an information report, Form 8308.

6. Code Section 704(c)(1)(B) provides that if property contributed by a partner is distributed by the partnership within seven years, the contributing partner is treated as recognizing gain or loss from the sale of the property in an amount equal to the gain or loss which would have been allocated to the partner under Code Section 704(c)(1)(A).

B. **General Rules– Basis of Acquiring Partner's Interest**

1. The purchaser of a partnership interest acquires a cost basis in that interest. Code Section 1012. This is sometimes called a partner's "outside basis."

2. However, the purchaser's basis in the assets of the partnership itself is not equal to the cost of the partnership interest. The acquiring partner's share of this basis (sometimes called the "inside basis") is not affected by the acquisition of a partnership interest.

3. This failure to receive a basis adjustment can be remedied by having the partnership make a Section 754 election. The effect of this election will be to have a basis adjustment in the partnership property apply with respect to (only) the incoming partner.

a. The basis adjustment resulting from a Section 754 election is referred to as a Section 743 adjustment.

b. When the Section 754 election is made, the basis of the overall partnership assets does not change. The Section 743 adjustment acts to give the incoming partner a separate basis for each asset represented by his or her interest. The partnership must maintain records to keep track of these adjustments.

c. Once the partnership makes a Section 754 election, it is binding for all of the partnership's future tax years.

d. The basis adjustment is allocated proportionately between the categories of assets, namely, capital assets and Section 1231 assets as the first category, and all other partnership property as the second category. The purpose of the basis adjustment is to reduce the difference between the fair market value and the basis of partnership's property.