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The Five Strategic Levels of Succession Planning for the Family Owned Business¹

By Sebastian V. Grassi, Jr. and Julius H. Giarmarco

Preface

One of the chief concerns facing family business owners is how to effect an orderly and affordable succession of the business² while ensuring that the business will provide for the future needs of the owner and his/her spouse and keep them comfortable during their retirement years. Failure to properly plan for a smooth succession during the owner's lifetime can result in monetary losses and even loss of the business itself. It is estimated that more than 70 percent of family owned businesses do not survive the transition from founder to second generation. However, given adequate time and proper planning, a business succession plan can be implemented easily and often profitably.

There are essentially FIVE LEVELS to a family business succession plan.

The FIRST LEVEL is to determine the business owner's long-term objectives for the family business.

The SECOND LEVEL is to determine the financial needs of the business owner and his/her spouse and to develop a viable plan that assures their financial security.

The THIRD LEVEL is to determine who will manage the business and to develop the management team. It is important to recognize that management and ownership of the business are not the same. The day-to-day management of the business may be left to one child, while ownership of the business is left to all of the children (whether or not they are active in the business). It is also possible that management may be left in the hands of key employees (or outsiders) rather than family members.

The FOURTH LEVEL is to determine who will own the business and how to transfer (gift, sell, or devise) the owner's interest in the business

to the "new" owner(s). Most business owners would prefer to leave their businesses to those children who are active in the business (the "active" children), but they would still like to treat all of their children fairly (if not equally). Yet, many business owners lack sufficient non-business assets to allow them to leave an equal share of their estate to the children who are not active in the business (the "inactive" children). Thus, a business succession plan must provide a means of transferring wealth to the children who are not interested in, or not qualified for, continuing the business. Business owners must also assess the most effective means of transferring ownership and the most appropriate time for the transfer to occur. Two other issues concerning ownership must be addressed. The first is whether the business owner will continue to receive economic benefits from the business after the transfer of ownership. This of course will depend on the financial needs of the business owner and his/her spouse, as well as the method used to transfer ownership of the business. The second issue is whether the business owner will continue to control the business after the transfer of ownership is complete.

The FIFTH LEVEL is to minimize transfer taxes and to prepare an appropriate estate plan. Estate taxes alone can claim up to 45 percent of the value of the business, frequently resulting in a business having to liquidate or take on debt to keep the business afloat. To avoid a forced liquidation or the need to incur debt to pay estate taxes, there are a number of lifetime gifting strategies that can be implemented by the business owner to minimize (or possibly eliminate) estate taxes.

Introduction

This article is a checklist of common issues and planning techniques in family business succession planning. The article summarizes the fundamentals of business succession planning to help family business owners assess their goals and consider the economic, legal and tax implications of various plans. Because business succession planning involves complex matters concerning family dynamics, business law, tax matters, and sundry legal issues, the only way to develop the best business succession strategy for a particular family business is to work closely with a lawyer, accountant, and a licensed financial advisor experienced in business succession planning. In some instances, it will also be necessary to hire a family business consultant who can help deal with family dynamics and facilitate the overall process of business succession planning.

Level One of a Family Business Succession Plan

Ascertain the Owner's Objectives

The FIRST LEVEL of a business succession plan is to determine the owner's objectives, i.e., the "what," "when," and "how" the owner wants his/her objectives to be accomplished. Ascertain- ing the business owner's objectives is necessary to determine the appropriate financial planning, retirement planning, business planning, business succession-transition planning, tax planning, and estate planning strategies for the owner.

Understanding the owner's objectives helps the owner's advisors establish an appropriate blueprint for transitioning the business. In developing the blueprint/recommendations, the owner's advisors must juxtapose the owner's objectives against the advisors' observations concerning the reality of the business and the owner's family situation. Comparing the present situation (base on the advisors' observations) against the owner's objectives will help determine if the ob-

jectives are in alignment with reality (or a high probability of becoming realistic). Thus, the blueprint/recommendations must, among other things, take into consideration the owner's objectives; the present situation concerning the business; the present situation concerning the owner's family dynamics; the constraints under which the business and the family currently (and most likely will) "operate;" and the value of the business, its cash flow, its competition, and its role/standing in the marketplace.

In a nutshell, the FIRST LEVEL involves determining and understanding the business owner's objectives; ascertaining the present situation and current constraints; observing the reality of the overall situation; and making realistic recommendations that are achievable by the owner and his/her business and family.

***Example:** John (age 55) is the sole shareholder of an S corporation that manufactures parts used in the automobile racing industry. It's a highly specialized business and John is dependent upon one key employee for product design and sales. John is married with two adult children, Tom (age 32) and Peter (age 30). Only Peter is active in the business, and John would like to see Peter take over the Company upon John's death, disability, or retirement. John also wants to treat Tom fairly (if not equally), but does not have enough non-business assets to accomplish this objective.*

Level Two of a Family Business Succession Plan

Financial Needs and Financial Planning

The SECOND LEVEL of a family business- succession plan involves the financial needs of the owner and his/her spouse. Many family business owners are "cash poor" but "rich on paper," dependent on the business to provide for their retirement in a life style to which they have become accustomed. Some owners may want to start a "new" life in retirement and branch out and

(finally) do those things they have put on hold for the many years they spent building and running the business. They may want to travel, spend more time with the grandchildren, become more involved in community activities, serve on non-profit boards, etc. Will the business be able to support the owner and his/her spouse after the succession? Can the business also support the children, who are now the “new” owners? If not, should the business be sold to a third party? In Level Five, below, there is a discussion of several techniques that can provide the owner with post-retirement “income” from the business.

If the owner’s goals and financial needs are out of synch, they will need to be brought into harmony. Consequently, a reality check will be necessary. In many instances, the owner mistakenly believes that the business is worth more than it actually is, and a business valuation may be necessary to convince the owner of the business’ true worth. Once the owner knows the true going concern value of his/her business, the owner will be better informed and be can make (more) informed decisions concerning personal goals and finances, especially concerning his/her retirement.

Example: *John’s CPA values the Company at \$10 million. The Company’s pre-tax profit has averaged \$1.5 million for its last three fiscal years. However, most of this profit has been used to expand the Company’s manufacturing capacity. Future profits should be available for distribution to the shareholders. John has received very little from the Company in the form of salaries, bonuses, and Subchapter S distributions. Thus, without assistance from the Company, John and his wife will not have enough savings to maintain their desired standard of living after John retires, or if John becomes disabled. John does have a \$3 million life insurance policy on his life to protect his wife in the event of his premature death. The policy is owned by an irrevocable life insurance trust (“ILIT”).³*

Level Three of a Family Business Succession Plan

Developing Management

The THIRD LEVEL of a family business succession plan involves the future management of the business.

Whether management of the business will rest in the hands of the next generation, in the hands of key employees, or a combination of both, the business owner must learn to delegate and work “on the business,” not just “for the business.” It can take many years to train the successor management team so that the business owner can transition from running the day-to-day operations of the business. For many business owners, giving up control can be difficult.

All too often, business owners focus more on the ownership and transfer tax issues involved in a business succession plan and ignore the people issues. In the typical family business, the future leader is likely to be one of the business owner’s children. If so, steps must be taken to assure that the future leader is qualified and has the support of the key employees and other family member owners. Generally, a gradual transfer of roles and responsibilities gives the successor time to grow into his/her new position and allows the business owner time to get used to his/her diminishing role. Thus, lead-time (typically three to five years) to select and mentor a successor is important for a smooth transition.

Many family businesses are dependent on one or two key employees who are critical to the success of the business. These key employees are often needed to manage the business (or assist in the management of the business) during the succession period. Therefore, the succession plan must address methods to guarantee that key employees remain with the business upon the death, disability, or retirement of the business owner. Following are four techniques often used to assure that a business’ key

employees remain with the business during the management succession period:

(1) Employment Agreements. A written employment agreement will establish the key employee's duties, compensation, and fringe benefits. The agreement can also provide for some form of profit sharing or incentive compensation, as well as a covenant-not-to compete. To protect the key employee, the agreement can have a set term and can provide the employee with severance pay if his/her employment is terminated without cause (as defined in the agreement).

(2) Non-Qualified Deferred Compensation Plans. A non-qualified deferred compensation ("NQDC") plan (sometimes referred to as a "golden handcuff" plan) is an agreement wherein the business promises to pay the key employee a benefit at retirement, death, and/or disability in return for the employee's continued employment through the specified age for retirement. If the NQDC plan is properly designed, the employee does not report income until the NQDC payments are received, and the business does not receive a deduction until the NQDC payments are made to the employee. The NQDC benefit is usually paid in monthly installments for a set term of years, and can be based on a set dollar amount, on a specified percentage of the employee's average final pay, or on the future value of the business (a so-called "phantom stock" plan). In exchange, the employee promises not to voluntarily terminate employment prior to the retirement date and not to compete with the business after retirement. An employee's violation of either promise can result in the forfeiture of all benefits promised to him/her under the agreement. The ideal way to fund an NQDC plan is for the business to purchase a life insurance policy on each

employee covered under the plan.

(3) Non-Qualified Stock Option Plans.

A non-qualified stock option plan is a contract between a Company and one or more key employees that gives the employee(s) the right to purchase a specific number of the Company's shares of stock at a fixed price within a certain time period. The price the Company sets on the shares of stock (called the "grant" or "strike" price), that the employee must pay for the stock when the employee exercises his/her option to purchase the stock, is usually the market price of the stock at the time the option is granted to the employee. If the underlying stock increases in value, the employee's option becomes more valuable. If and when the option to purchase the stock is exercised (and paid for) by the employee at the grant/strike price, the employee must pay income tax on the amount of the "spread" (the difference between the current fair market value of the stock and the amount the employee pays for the stock when the employee exercises the option to purchase the stock). At the time of the employee's exercise of his/her option to purchase the stock, the Company receives an income tax deduction for the amount of the spread. To encourage a key employee to remain with the Company following the owner's death, disability or retirement, the option can include a vesting period. Finally, to assure that the stock remains in the hands of insiders, the agreement can contain provisions that restrict the transfer of both the option and the shares (when purchased) to outsiders.

(4) Change of Control Agreements. A change of control agreement generally provides that the key employee's terms and conditions of employment (i.e., duties, compensation, benefits, etc.) will not

be adversely changed for a set period (usually one to three years) following the transfer of the business to the next generation of owners. Thus, if the new owners terminate the key employee's employment for reasons other than death, disability, or termination for cause (as defined in the agreement), the employee will continue to receive his/her compensation and benefits for the remainder of the set period.

Example: *To assure that the key employee remains with John's Company, the Company has offered the key employee a NQDC plan. Under the NQDC plan, the key employee will receive a retirement, disability, or pre-retirement death benefit if the key employee remains with the Company until the key employee's normal retirement age (60 years). The benefit is based on the key employee's final average pay. In addition, to assure that the key employee remains with the Company to assist Peter in the event of John's death, disability, or retirement (i.e., a change of control), the Company has agreed to pay the key employee a percentage of its profits following the change of control.*

To assist the successor managers during the management succession period, the business owner should consider establishing an advisory board. Upon the business owner's death, disability, or retirement, the advisory board can provide counsel to the successor managers and suggest strategic policy. The advisory board can be comprised of key employees, customers, suppliers, the business's attorney, accountant, financial advisor, and/or other business owners. The advisory board can be established in the business's governing documents (i.e., the bylaws for a corporation or the operating agreement for an LLC) or as part of the business owner's estate plan. For example, a business owner's revocable living trust can establish an advisory board upon the business owner's death or incapacity to manage the business during the transition period.

Level Four of a Family Business Succession Plan

Transferring Ownership

Often, a major concern for family business owners with children who are active in the business (the "active children") is how to treat all of the children equally in the business succession process. Other concerns for the business owner include when to give up control of the business and how to be guaranteed sufficient retirement income. Following are ten techniques commonly used to resolve these concerns:

- (1) Sell The Business to the Active Children.** Selling (as opposed to gifting) the business to the active children results in all children being treated equally. The sale price would be the fair market value of the business determined by an independent appraisal. Typically, the purchase price will be paid in installments with interest. An added advantage of a sale is that it provides an income stream for the business owner's retirement needs. The problem with a sale, however, is that it is not tax efficient. The purchasers must use after-tax dollars to make the principal payments, and the business owner must pay a capital gains tax on any gain realized on the sale plus ordinary income taxes on the interest payments. (If the business owner wants to avoid the recognition of capital gain, consider having the business owner sell the business interest to an intentionally defective grantor trust, which is discussed below.)
- (2) Use Voting and Non-Voting Shares.** Gift and/or sell the business to all of the children, but transfer voting shares to the active children and non-voting shares to the inactive children. In addition, grant either the business and/or the active children the right to call (purchase) the non-voting shares of the inactive children.

Conversely, grant the inactive children the right to put (sell) their non-voting shares to the business and/or the active children. The purchase price and payment terms for the puts and calls must be in writing.

- (3) Leave Non-Business Assets to the Inactive Children.** Gift and/or sell the business to the active children, and leave the non-business assets to the inactive children. If the inactive children will not receive an equal (or fair) portion of the business owner's estate, the business owner can make up the difference by establishing an ILIT for the inactive children's benefit.
- (4) Reward the Active Children for Their Sweat Equity.** If the active children have been instrumental in the success of the business, give them credit for their involvement in the business, particularly if their compensation package has been less than the going rate. This credit can be in the form of lifetime gifts of business interests and/or a larger portion of the business owner's estate (in the form of business interests) compared to the inactive children.
- (5) Equality vs. Fairness.** Generally, it is not necessary to treat adult children equally under state law. Therefore, a business owner need not base his/her business succession plan on treating the inactive children equally, or even fairly. Of course, treating one's children unequally can create acrimony between the siblings.
- (6) Provide Written Assurance to the Active Children.** For the active children, the most pressing need is likely the assurance (in writing) that they will eventually control the business upon the owner's death, disability, or retirement. For the business owner, the need to control the business for the time being is likely to be of utmost importance. Therefore, the parties can enter into a buy-sell agreement (see below) that

allows the business owner to retain the voting shares until his/her death, disability, or retirement.

- (7) Maintain Control By Retaining Voting Shares.** If more than one child is active in the business and the business owner is not certain which of the active children should have control over the business, the business owner can retain the voting shares until that decision is made. However, the business owner's revocable living trust should distribute the voting shares to one or more of the active children (or hold them in trust for the benefit of such children) in the event the business owner dies or becomes disabled/incompetent before he or she completes the transfer of the voting shares.
- (8) Establish Criteria for the Active Children to Receive Voting Shares.** When more than one child is active in the business, specific criteria that the children must meet in order to receive voting shares can be established. For example, earning a college degree or obtaining outside work experience are common requirements.
- (9) Provide the Business Owner With a Salary Continuation or Consulting Agreement.** If the decision is made to gift the business to the active children, a salary continuation agreement (which is a form of NQDC) can be used to provide the business owner with retirement benefits. If properly designed, the benefits paid to the business owner will be deductible to the business but taxable as ordinary income to the business owner. Alternatively, the business owner can remain as a consultant to the business or serve as a board member in order to receive some compensation.
- (10) Protect the New Business Owners With a Buy-Sell Agreement.** Simultaneous with the gifting and/or selling of busi-

ness interests, the new owners should enter into a buy-sell agreement.⁴ A buy-sell agreement is a legal arrangement providing for the redistribution of shares of the business following the death, disability, retirement, or termination of employment (triggering events) of one of the owners. The buy-sell agreement should also set forth the purchase price formula and payment terms upon the occurrence of a triggering event. A buy-sell agreement can also contain special provisions concerning S corporation matters, such as mandatory minimum distributions of S corporation income to shareholders so they can pay income taxes on undistributed S corporation income that is currently taxable to them.⁵ If properly designed and drafted, a buy-sell agreement will create for the departing owner a market for what otherwise could be a non-marketable interest in a closely held business; will allow the active children to maintain control over the business by preventing shares from passing to the inactive children; and, if the requirements of IRC section 2703 are met, the buy-sell agreement will fix the value of a deceased owner's shares for estate-tax purposes.⁶

Example: *To minimize estate taxes, John has decided to start transferring his shares in the Company to Peter. Before transferring any shares, however, John has the Company recapitalized into voting and non-voting shares. John will transfer the non-voting shares to Peter. By transferring the non-voting shares, John remains in control of the Company (until he is ready to transfer the voting shares to Peter). In addition, the value of the non-voting shares will be discounted (for lack of control and marketability) thereby making it easier to gift and/or sell the shares to Peter. Simultaneous with any such stock transfers, Peter will enter into a buy-sell agreement with the Company to assure that his shares do not end up in the hands of non-family members.*

Level Five of a Family Business Succession Plan

Transfer Tax Minimization

The transfer tax component of business succession planning involves strategies to transfer ownership of the business while minimizing gift and estate taxes. Gift tax and estate tax consequences deserve special attention. Unanticipated federal estate taxes can be so substantial that the business may need to be liquidated to pay the tax.

Currently, the federal estate tax is eliminated for persons dying in 2010, but it is reinstated in 2011. In the meantime, the estate tax exemption is \$3.5 million in 2009 and \$1 million in 2011 and thereafter. For estates above the exemption amounts, the maximum federal estate tax rate is 45 percent in 2007-2009, and 55 percent in 2011 and thereafter. However, in the view of many experts, Congress is likely to reform the present system before 2010, but it will probably not repeal the federal estate tax. Moreover, since 1981, there have been no estate taxes on transfers between spouses, if the surviving spouse is a U.S. citizen.

Following is a description of a number of tools and techniques commonly used to transfer ownership of a family owned business. The factors to be considered in determining which techniques to use include the size of the business owner's taxable estate, the owner's need for retirement income, the owner's desire to control the business during the succession period, and the desire to treat the inactive children equally or fairly.

For lifetime gifts or sales of the business, minority shares or non-voting shares are usually used for two reasons. First, they are used to accomplish the business owner's objective to retain control of the business until a later date (i.e., the owner's death, disability, or retirement). Second, they are used to lower the gift-tax value of the business interests due to valuation discounts

for lack of control and marketability.

Gifting Techniques

Annual Exclusion Gifts. Gifts of business interests up to \$13,000 (\$26,000 for married couples) in 2009 can be made annually to as many donees as the business owner desires. This amount is adjusted for inflation in increments of \$1,000. Gifts not only remove the value of the business interests gifted from the business owner's estate but also the income and future appreciation on the gifted business interests.

Gift Tax Exemption. Beyond the \$13,000 gift tax annual exclusion (\$26,000 for a married couple), indexed for inflation, the business owner can gift \$1 million (\$2 million for a married couple) during his/her lifetime. While the use of the \$1 million/\$2 million gift tax applicable exclusion amount reduces (dollar for dollar) the estate tax exemption at death, such gifts remove the income and future appreciation on the gifted property from the business owner's estate. Unlike the estate tax exemption (which is \$3.5 million in 2009), the gift tax exemption remains fixed at the \$1 million level.

Gifts of Family LLC Interests. A family limited liability company ("FLLC") is a standard LLC that only includes family members. It can be a valuable tool to transfer a business or business real estate to children at a discount from the value of the underlying assets owned by the FLLC. This is accomplished by gifting or selling minority interests or non-voting interests in the FLLC to the children (or to trusts for their benefit). In other words, the sum of the FLLC's parts is worth less than the whole.

If the business owner desires to retain control of the FLLC (but not be a majority owner of the FLLC), one alternative is for the business owner to own 49 percent or less of the voting interests in the FLLC and "team up" with a "friendly" child whose interest, when combined with that of the business owner, is 51 percent or more. If the business owner is married, the business owner can, for example, own 26 percent of the FLLC

and the spouse can also own 26 percent of the FLLC. Together, the business owner and his/her spouse would own 52 percent of the FLLC, giving them control. However, when the first spouse dies, only 26 percent of the FLLC would be includable in his/her estate, and the 26 percent interest should qualify for minority interest and lack of control valuation discounts (as well as other possible valuation discounts).⁷ The same results can be accomplished with a family limited partnership ("FLP").

Another alternative for a business owner who desires to retain control of the FLLC (but not be a majority owner of the FLLC), is for the business owner to retain the voting interests in the FLLC and gift non-voting interests in the FLLC. The non-voting interests, which can comprise 99 percent of the FLLC's ownership interests), should qualify for minority interest and lack of control valuation discounts (as well as other possible valuation discounts). The same results can be accomplished with an FLP.

Gifts in Trust. While a business owner can gift shares in the business outright, consideration should be given to making the gifts in trust. One advantage of making gifts in trust for the benefit of the active children is to protect them from their inability, their disability, their creditors, and their predators, including divorced spouses. Another advantage to making gifts in trust is that the assets in the trust at the children's deaths can (within limits) pass estate-tax free to the business owner's grandchildren through a generation-skipping or dynasty trust.

Gift to Charity and Corporate Repurchase. C corporation business owners who are charitably inclined, can gift some shares to children and the balance to charity. Several months later, the corporation can then redeem (i.e., repurchase) the charity's shares, leaving the charity with liquid assets and the children as the sole shareholders of the corporation. As long as the charity is a public charity, the redemption of the charity's shares may be achieved with either cash or a note. The net effect of using this technique is

to reduce the number of shares that will eventually need to be transferred to the active children. This strategy saves income, gift, and future estate taxes. The business owner receives a current charitable income tax deduction, avoids capital gains taxes, and reduces his/her gift and estate taxes. It is important that there be no pre-arranged agreement that the charity's shares will be redeemed. Specifically, on the date of the gift to the charity, neither the corporation nor the charity may be bound to effect a redemption. However, a mere understanding concerning the sale of the stock is permitted under Rev. Rul. 78-197, 1978-1 C.B. 83, provided the "understanding" is not legally binding.

Example: *While John and his wife can use their \$26,000 annual gift tax exclusion and \$2,000,000 gift tax exemption to make gifts of John's non-voting shares in the Company to Peter, only a portion of John's shares can be transferred by gifting because of the value of the Company. Thus, while gifting will certainly play a role in transferring the Company to Peter, it will be used in conjunction with one of the sales strategies or estate freezing techniques discussed below.*

Sales Strategies

Installment Sales. An installment sale is an excellent way to provide a steady stream of cash flow (and retirement income) to the business owner while transitioning ownership of the business to the active children. The installment sale must bear interest at not less than the applicable federal rate published monthly by the IRS. To the extent that the purchase price is less than the fair market value of the shares, the business owner has made a gift to the purchaser (i.e., a bargain sale).

Private Annuities. With a private annuity, the business owner (the annuitant) sells the business interest to the active children (the purchasers) for an unsecured promise to make periodic payments to the annuitant for the remainder of the annuitant's life (a single life annuity) or for the remainder of the lives of the annuitant and

his/her spouse (a joint-and-survivor annuity). The size of the annuity payments is dependent on the business owner's life expectancy. Since the payments terminate upon the business owner's death, neither the business interest nor the annuity is included in the business owner's estate for estate tax purposes. Because the private annuity is a sale and not a gift, it allows the business owner to remove the business interest (and the future income and appreciation thereon) from his/her estate without incurring gift or estate tax. The business owner must recognize any capital gains in the year of sale. Thereafter, each annuity payment in excess of the seller's ratable basis is taxed as ordinary income. The annuity cannot be secured (however, the IRS in proposed Treasury Regulations is reconsidering its prohibition of a secured private annuity) and the purchaser cannot deduct any portion of the payments.

Where there would be little or no capital gains recognition by the seller, a private annuity is an excellent vehicle for a business owner who wants to sell a business during his/her lifetime and receive income until he/she dies. Of course, there is always the possibility that the business owner will outlive his/her life expectancy, in which case the children purchasing the business will pay more than expected. Private annuities can be particularly helpful from an estate tax perspective when the business owner is in poor health and not likely to live out his/her life expectancy. The business owner could sell the business to the active children who would only make payments until the owner's death. Thus, the children could pay very little for the business. However, in order to rely on the IRS's actuarial tables to determine the amount of the annuity (as opposed to the owner's actual life expectancy), the business owner must have a 50 percent chance of living one year beyond the private annuity agreement. If the business owner lives for at least 18 months beyond the private annuity agreement, there is generally no challenge by the IRS. In any event, a medical assessment to document the business owner's health condition should be

obtained when entering into a private annuity arrangement

Self-Canceling Installment Notes. When a business owner decides to sell his/her business to a child on an installment basis, the promissory note may be a self-canceling installment note (“SCIN”). With a SCIN, upon the seller’s death, all remaining payments under the note are canceled, similar to a private annuity. The purchaser must, however, pay a premium for this cancellation feature, in the form of either a higher interest rate or a larger purchase price. Like a private annuity, an SCIN avoids estate and gift taxes. However, unlike a private annuity (which results in the seller’s immediate recognition of gain), gain under an SCIN is recognized by the seller as payments are received. However, when the seller dies, any unrecognized (i.e., cancelled) gain at the seller’s death under the SCIN is reportable either on the seller’s final IRS form 1040 or on the seller’s estate’s IRS form 1041.

***Example:** Since John and his wife are dependent upon the Company for their retirement needs, they considered gifting some of John’s non-voting shares to Peter, and selling the balance of the non-voting shares to Peter for a joint and survivor private annuity or an SCIN. However, they decide against a private annuity sale because of the capital gains tax John would have to immediately pay. They were also concerned that a private annuity would unnecessarily increase their estate if they lived past their life expectancy. For similar reasons, they decide against using an SCIN.*

Estate Freezing Techniques

Grantor Retained Annuity Trusts. A grantor retained annuity trust (“GRAT”) is an irrevocable trust to which the business owner transfers shares in his/her business (typically Subchapter S stock or interests in an LLC or FLP) but retains the right to a fixed annuity (payable not less than annually) for a stated term of years. At the end of the stated term, which must expire during the business owner’s lifetime, the property remain-

ing in the GRAT (i.e., the appreciation and income in excess of the annuity amount that is to be paid to the business owner) will pass to the active children. Only the value of the remainder interest (passing to the active children) is subject to gift tax. Thus, the larger the annuity, the longer the stated term, and the lower the IRS assumed interest rate, the smaller the gift (of the remainder interest) to the active children. It is possible to structure a GRAT so that there is little or no gift tax payable on the value of the remainder interest that passes to the active children. For gift tax purposes, this is known as a “zeroed-out” GRAT. If the zeroed-out GRAT produces a return in excess of the annuity amount payable to the business owner, the GRAT will succeed in passing on the remainder interest (i.e., the trust’s excess income and appreciation to the active children) at little or no gift tax cost to the business owner. If the zeroed-out GRAT fails to produce a return in excess of the annuity amount and the remainder beneficiaries receive nothing, there is no “downside” since there was little or no gift tax cost to the business owner when he/she established the zeroed-out GRAT. From a gift tax point of view, using a zeroed out GRAT is a “heads you win, tails you don’t lose” estate planning technique.

The downside with a GRAT (especially a short-term GRAT) is that if the business owner fails to survive the stated term, most, if not all, of the property in the GRAT will be included in his/her estate.

Estate freezing with a GRAT occurs because the future appreciation and income on the business interest (in excess of the annuity amount payable to the business owner) is removed from the business owner’s estate. The business owner’s estate is also reduced by the income and capital gains taxes he/she must pay on the GRAT income. In other words, the business owner is not taxed separately on the annuity payments but, instead, is taxed on all of the capital gains and income realized by the GRAT. The income and capital gains taxes paid by the business owner on the GRAT’s income and capital gains are ef-

fectively tax-free gifts to the remainder beneficiaries of the GRAT—a double tax benefit!

Installment Sales to Intentionally Defective Grantor Trusts. The business owner can sell shares in his/her business (typically Subchapter S stock or interests in an LLC or FLP) to an intentionally defective grantor trust (“IDGT”) for the benefit of the active children. An IDGT is an irrevocable trust that is valid for estate tax purposes, but “defective” for income tax purposes. This means the business owner (as the grantor of the IDGT) is the owner of the IDGT for income-tax purposes but is not treated as the owner of the IDGT for estate tax purposes. Since the business interests are sold to the IDGT, there are no gift taxes.⁸ Moreover, there are no capital gains taxes to the business owner because sales between a grantor and an IDGT are disregarded for income tax purposes. Under the usual terms of the sale, there is no down payment to the IDGT, annual interest payments are at the lowest rate permitted by the IRS, and a balloon principal payment is due in nine or more years. This technique is similar to a GRAT, but without the mortality risk.

Estate freezing with an IDGT occurs because the future appreciation and income on the business interest (in excess of the interest rate) are outside the business owner’s estate. The business owner’s estate is also reduced by the income and capital gains taxes he/she must pay on the IDGT’s income. In other words, the business owner is not taxed separately on the interest payments but instead is taxed on all of the capital gains and income realized by the IDGT. The taxes paid by the business owner on the IDGT’s income and capital gains are effectively tax-free gifts to the beneficiaries of the IDGT—a double tax benefit! Finally, the installment note from the IDGT can be in the form of a SCIN or a private annuity (see above).

Example: *John considers both a GRAT and an IDGT, and he decides to transfer his non-voting shares to Peter with an IDGT. John favors the IDGT transaction over the GRAT for several rea-*

sons. First, there is no mortality risk with an IDGT. Second, the IDGT makes more effective use of John’s generation skipping transfer (“GST”) tax exemption because it can be allocated to the IDGT at the onset of the transaction. Because of the GST estate tax inclusion period (“ETIP”) rules, GST tax exemption allocation cannot be effectively allocated to a GRAT until the end of the GRAT term. Third, the interest rate used in connection with an IDGT may be less (i.e., the mid-term applicable federal rate (“AFR”) for a nine year note as opposed to 120 percent of the mid-term AFR for a GRAT). Finally, unlike a GRAT, an IDGT allows for a backloading (i.e., interest only payable annually, with a balloon payment of principal in nine or more years).

Statutory Relief

IRC Section 303 Stock Redemption. Generally, the redemption of stock in a closely held corporation is taxed as a dividend (to the extent of earnings and profit). IRC section 303 makes an exception to the general rule for sales by an estate or heir (to the extent of the estate tax and certain other administration expenses). This exception results in the taxation of the gain on the sale at capital gains rates. Since the stock receives a new basis equal to its value on the date of death, the estate or heir will recognize no gain on the sale. In order to qualify for IRC section 303 treatment, the stock to be redeemed must be included in the deceased shareholder’s estate, and the value of the stock must exceed 35 percent of the deceased shareholder’s adjusted gross estate. The primary benefit of IRC section 303 is to permit the tax-free use of a closely held corporation’s cash to pay a deceased shareholder’s estate tax (and certain other administration expenses).

IRC section 6166. Generally, the federal estate tax is due and payable in cash within nine months of death. IRC section 6166 provides a way for estates of closely held business owners to spread out their estate tax payments. If the value of the closely held business is more

than 35 percent of the business owner's adjusted gross estate, then the estate taxes attributable to the business interest may be deferred for four years during which only interest on the tax is due. Thereafter, the business owner's estate is allowed up to a maximum period of ten years, to make annual payments of principal and interest. However, the number of qualifications and restrictions (including security requirements) that must be met in order to defer estate taxes under IRC section 6166 often relegates its use to a planning technique of last resort.

IRC section 6166 can be used in conjunction with a *Graegin* loan, named after the court case that validated this technique, or a *Graegin* loan can be used as an alternative to IRC section 6166. A *Graegin* loan is a loan from a related party (typically a family member or an entity that is controlled by the business owner's family) to the business owner's estate. The loan interest paid by the business owner's estate remains in the family, and the business owner's estate can deduct the interest on the estate tax return—a double benefit!

Life Insurance Applications

Life insurance often plays an important role in a business succession plan. Following are some of the common ways that life insurance can be integrated with many of the tools, techniques, and strategies discussed in this article.⁹

Estate Liquidity. Some business owners will wait until death to transfer all or most of their business interests to one or more of their children. If the business owner has a taxable estate, life insurance can provide the children who receive the business with the cash necessary for them to pay some or all of the business owner's estate taxes. Using life insurance to pay estate taxes is particularly useful to business owners because business interests cannot be readily liquidated. Life insurance is also a much easier (and less expensive) alternative to deferring taxes under IRC section 6166.

The children receiving the business may also

need life insurance to pay estate taxes at their deaths. Typically, the insurance policy will be owned by an ILIT so that the beneficiaries will receive the death proceeds both income and estate tax free—a double tax benefit!

Estate Equalization. A business owner can use life insurance to provide those children who are not involved in the business with equitable treatment. Leaving the business to the active children and life insurance to the inactive children equalizes the inheritances among all of the children. It also avoids the need for the active children to purchase the interests of the inactive children—perhaps at a time when the business may be unable to afford it. Depending on the particular facts and circumstances, the insurance may be owned by an ILIT for the sole benefit of the inactive children.

Buy-Sell Agreements. A properly designed buy-sell agreement can guarantee a market and fair price for a deceased, disabled, or withdrawing owner's business interest; ensure control over the business by the surviving or remaining owners; and, if the buy-sell agreement meets the requirements of IRC section 2703, the agreement can set the value of the business interest for estate-tax purposes.¹⁰ Life insurance is the best way to provide the cash necessary for the business or the surviving owners to purchase a deceased owner's interest. In many instances, the cash surrender value in a life insurance policy can also be accessed income tax free (by surrendering to basis and borrowing the excess) to help pay for a lifetime purchase of a business owner's interest.

Nonqualified Deferred Compensation Plans. A NQDC plan can be used by a small business to provide members of the senior generation with death, disability, and/or retirement benefits. An NQDC plan may be particularly useful in those situations where the senior members have transitioned the business to the junior members and the senior members are no longer receiving any compensation from the business. An NQDC plan is also useful to ensure that key

employees remain with the business during the transition period—a so-called golden handcuff. Because life insurance offers tax-deferred cash value growth and tax-free death benefits, it is the most popular vehicle for “informally” funding NQDC plan liabilities.

Key Person Insurance. Many family businesses depend on non-family employees for the Company’s continued success. To guard against financial loss due to the absence of an indispensable key employee, many companies take out key person life insurance, disability insurance, or both.

Section 303 Redemptions. IRC section 303 allows the estate of a business owner to remove cash from a corporation with no tax cost. To ensure that the corporation has sufficient funds with which to accomplish the IRC section 303 redemption, the corporation can purchase a life insurance policy on the shareholder’s life.

Hedge Strategy. Life insurance can also be used to provide a hedge against the business owner’s premature death in several of the techniques described in this article. For example, if the business owner establishes a GRAT and dies before the end of the stated annuity term, life insurance could be used to pay the estate taxes on the GRAT assets that will be included in the business owner’s estate. In addition, if a sale with a private annuity is used, life insurance could provide funds for the business owner’s spouse (and/or other family members) since the annuity payments would terminate on the business owner’s death. Similarly, life insurance can provide funds for the business owner’s spouse and other family members should the business owner die prematurely after selling the business for an SCIN. In all of these situations, it is advisable to have the life insurance owned by an ILIT so that the insurance proceeds will escape estate taxes.

Family Bank. When the decision is made to leave the business to both active and inactive children, it is usually advisable to leave the active children with voting interests and the inac-

tive children with non-voting interests in the business. In addition, put and call options should be given. Generally, a put option given to the inactive children allows them to require the active children (or the business itself) to purchase all or a portion of their interest in the business at a set price and terms. Without a put option, there may be no practical way for an inactive child to benefit from owning the business interest unless and until the business is sold (if ever). Conversely, a call option given to the active children (or the business itself) allows them to purchase the business interests of the inactive children upon a set price and terms. Without a call option, there may be no effective way for the active children to avoid the obvious conflicts that can occur between the active children who are receiving salaries and bonuses and the inactive children who are not. By having the active children own life insurance on the business owner’s life, a “bank” is created to provide the funds to satisfy any such puts and calls. Typically, the policy will be owned outside of the business entity, such as in a trust for the benefit of the active children or by a LLC owned by the active children.

Example: *After entering into the IDGT transaction, John and his wife purchase a survivorship policy owned by an ILIT for the benefit of Tom. The insurance proceeds will be used to “equalize” the amounts passing to Tom and Peter. A second survivorship ILIT for the benefit of Peter can be established to provide the funds to pay the estate taxes that will be due on the note payable to John by the IDGT. In both cases, the Company can assist in the payment of premiums under a split dollar arrangement.*

Conclusion

Business succession planning is critical to ensuring the continuation of any family owned business, particularly if the owner plans to retire in ten years or less. An effectively developed succession plan provides for a smooth transition in management and ownership with a minimum of transfer taxes. Additionally, a business succes-

sion plan can provide financial security and freedom to the retired business owner and his/her spouse. Given the number and complexity of transition and succession options available, effective business succession planning requires time, the assistance of outside advisors, the input of family members (especially the owner (and the owner's spouse) concerning his/her goals), and the willingness to address interpersonal conflicts that can arise during the planning process. Once completed, the business succession plan will provide peace of mind for the business owner and key employees, personal satisfaction for family members, and new opportunities for the business itself.

Notes

1. This article is a general overview of various family business succession planning techniques and does not provide an exhaustive discussion of all the tax issues, tax traps, and other sundry issues that could arise when using any of the techniques. Accordingly the reader should consult with competent legal and tax counsel concerning the techniques discussed in this article.

See, Sebastian V. Grassi, Jr., "Estate Planning for the Closely Held Business after the Pension Protection Act of 2006," 32 *Tax Management Estates, Gifts and Trusts Journal* 87 (March 8, 2007); and Mezzullo, 809-2nd T.M., *Estate Planning for Owners of Closely Held Business Interests* for a discussion of the tax issues concerning many of the techniques discussed in this article.

See also, Julius H. Giarmarco and Sebastian V. Grassi, Jr., "The Ten Strategic Levels of Estate Planning," 28 *Mich Prob & Est Plan J*, No. 1 (Winter 2008) for an overview of 10 preliminary estate planning techniques that are available to reduce a taxable estate.

2. References to a "business" in this article include corporations, limited liability companies ("LLC"), and partnerships. References to shares include stock in a corporation, membership interests in a LLC, and partnership interests in a partnership.

3. See, Sebastian V. Grassi, Jr., *A Practical Guide to Drafting Irrevocable Life Insurance Trusts (with Sample*

Forms and Checklists) (Second Edition), ALI/ABA, Philadelphia, PA (2007), (800) 253-6397 (www.ali-aba.org/ali-aba/BK45).

4. See, Sebastian V. Grassi, Jr., "Recent Business and Tax Law Changes That Affect Buy-Sell Agreements," 73 *Michigan Bar Journal* 336 (March 1994) for a general overview of buy-sell agreements.

5. See, Sebastian V. Grassi, Jr., "Special Provisions for S Corporation Shareholder Agreements," 66 *Michigan Bar Journal* 1122 (November 1987).

6. Buy-sell agreements among family members that are entered into (or substantially modified) after October 8, 1990 are subject to special/additional rules concerning the agreement's ability to establish the value of the shares for transfer tax purposes.

7. To avoid the aggregation of the two spousal interests upon the death of the surviving spouse, the deceased spouse's 26% FLLC interest should be left to either a QTIP trust and/or credit shelter trust for the benefit of the surviving spouse. See, Section 12.4 of Sebastian V. Grassi, Jr., *A Practical Guide to Drafting Marital Deductions Trusts (with Sample Forms and Checklists)*, ALI-ABA, Philadelphia, PA (2004, Supp. 2008) (800) 253-6397 (www.ali-aba.org/aliaba/bk36).

8. However, for estate tax purposes the IDGT should own assets independent of the business that the IDGT is going to purchase. Thus, the business owner should transfer a "seed" gift to the IDGT. Typically the business owner will transfer to the IDGT a "seed" gift amount equal to 10% of the value of the assets to be purchased by the IDGT. In order to ensure full grantor trust status for the IDGT, the IDGT beneficiaries are typically not given *Crummey* withdrawal rights over the 10% "seed" gift. Thus the "seed" gift amount will not qualify for the gift tax annual exclusion and the business owner will have to use some of his/her \$1 million gift tax applicable exclusion amount when "seeding" the IDGT. *But see*, Priv. Letter Ruls. 200729005 thru 200729016 (full grantor trust status under the "tie breaker" rules of IRC section 678(b), even though the trust beneficiaries had *Crummey* withdrawal rights).

9. See, Chapter 1 of Sebastian V. Grassi, Jr., *A Practical Guide to Drafting Irrevocable Life Insurance Trusts (with Sample Forms and Checklists)* (Second Edition), ALI/ABA, Philadelphia, PA (2007), (800) 253-6397 (www.ali-aba.org/aliaba/BK45) for a discussion of the twenty-two benefits of life insurance and ILITs.

10. Buy-sell agreements among family members that are entered into (or substantially modified) after October 8, 1990 are subject to special/additional rules concerning the agreement's ability to establish the value of the business interest for transfer tax purposes.



Sebastian V. Grassi, Jr. of Grassi & Toering, PLC, located in the Detroit suburb of Troy, Michigan, is a member of the Christian Legal Society, where he served on its national board of directors. Listed in *The Best Lawyers in America*, and in *Michigan Super Lawyers*, Sebastian

is a Fellow of the American College of Trust and Estate Counsel ("ACTEC"), and has served as a member of the Michigan Probate and Estate Planning Council. Sebastian's practice emphasizes business law, business succession planning, estate planning and probate, special tax counsel to trustees and executors concerning complex tax issues, and related real estate matters. Sebastian has published over 95 articles on business law, estate planning, and tax matters in *Probate & Property*; *ACTEC Journal*; *Estate Planning*; *Journal of Practical Estate Planning*; *The Journal of Taxation*; *The Journal of Taxation of Estates and Trusts*; *Michigan Bar Journal*; *Michigan Probate & Estate Planning Journal*; *Michigan Tax Lawyer*; *Probate Practice Reporter*; *Tax Management Estates, Gifts and Trusts Journal*; *Wealth Strategies Journal*; *Practical Tax Strategies*; *The Practical Lawyer*; *The Practical Tax Lawyer*; and *Tax Ideas*. Sebastian is also a winner of the prestigious American Bar Association's *Probate & Property* "Probate & Trust Excellence in Writing Award for Best Practical Use Article." Sebastian is a frequent lecturer for the State Bar of Michigan's Institute of Continuing Legal Education. He also serves on the Institute's Estate Planning Advisory Board, and has served on the Estate Planning Advisory Board of the American Law Institute - American Bar Association ("ALI-ABA"). Elsewhere, Sebastian has lectured at the Electronics Industry Management College, Beijing, Peoples Republic of China, at various ACTEC meetings, at various Probate and Estate Planning Bar Associations, The Michigan Probate Registers Annual Conference, The Annual Great Plains Federal Tax Institute,

The Annual Minnesota Probate and Trust Law Section Conference, The Annual Notre Dame Tax and Estate Planning Institute, The National College of Probate Judges, the ALI-ABA, as well as at the University of Michigan Law School. Sebastian is the author of three books on estate planning and tax matters: *A Practical Guide to Drafting Irrevocable Life Insurance Trusts (With Checklists and Sample Forms) - Second Edition*, *A Practical Guide to Drafting Marital Deduction Trusts (With Checklists and Sample Forms)*, and *A Practical Guide to Drafting Irrevocable Life Insurance Trusts (With Checklists and Sample Forms)*. He is also the author of *Understanding Your Eternal Estate Plan*.



Julius H. Giarmarco is a partner in Giarmarco, Mullins & Horton, PC in Troy, Michigan, and is the chair of the firm's Trusts and Estates Practice Group. His primary practice areas include estate planning, business succession planning, wealth transfer, and life insurance applications. Julius lectures frequently on a national basis to insurance companies and various affiliated organizations, such as the International Forum, the Association for Advanced Life Underwriting (AALU), and the Million Dollar Round Table (MDRT). Julius is a co-author of the book, *Estate Planning with Insurance*, and is a major contributing author to two American Law Institute-American Bar Association books on estate planning, *A Practical Guide to Drafting Irrevocable Life Insurance Trusts (With Checklists and Sample Forms) - Second Edition* (<http://www.ali-aba.org/aliaba/BK45>), and *A Practical Guide to Drafting Marital Deduction Trusts (With Checklists and Sample Forms)* (<http://www.ali-aba.org/aliaba/BK36>).