Business Succession Planning 101

Jennifer J. McEwen
Harris H. Anthony
Maynard, Cooper & Gale, P.C.
1901 Sixth Avenue North
Regions Harbert Plaza, Suite 1700
Birmingham, Alabama 35203

Family businesses continue to be an integral part of the fabric of the American economy, constituting a significant percentage of the Fortune 500's largest companies, creating jobs and decreasing the national unemployment rate, and contributing to a large percentage of America's gross national product. Despite the large presence of family-owned or family-controlled businesses in the American marketplace and their significant contributions thereto, only a handful of such businesses survive into successive generations, in large part because of the difficulties and challenges associated with advising and planning with respect to family businesses' operations, ownership and management succession. As a result, those family businesses endeavoring to transfer management responsibilities and actual ownership, whether to family, to co-owners or to a third party buyer, and whether by gift, sale or a combination of both, frequently embrace many of the tools employed by non-family owned competitors.

At its core, business succession planning is comprised of two fundamental elements – the family and the business. In any business succession plan, adequate attention should be given to both elements. Advisors to a family business must, on the one hand, engage and advise the family in the transfer of assets and the transition of roles and, on the other hand, counsel the company and its officers and directors, who may be members of the ownership family, on operations, administration and finance, sales and marketing, as well as recruitment and retention of talent, diversification, innovation, governance and management succession. Open and honest communication among the current executives of the business and family members is essential to avoid hostility, resentment and conflict and to ensure that business and familial relationships are strengthened. While the two fundamental elements might generally run on two separate, distinct tracks, business succession planning will, in all likelihood, force an intersection of the two, demanding much of an advisor's attention, experience and expertise, and of course, his or her patience.

Business succession planning is hardly one size fits all; a plan or approach that may have worked for one business, or even for a prior generation, may not necessarily work for another business, or a succeeding generation. Current business owners should begin thinking about and planning for business succession as early and as often as possible.[1] Develop an initial (or emergency) plan and stick to it, but, of course, be flexible and revisit the plan as circumstances, family related and/or business related, change and evolve over time. We generally recommended that a family or closely-held business owner revisit his or her business succession plan upon the occurrence of unexpected health issues, next generation management/leadership readiness, opportunities to exit and maximize value and changes in the industry, whether such changes be of a regulatory or competitive nature.

I. Management Succession Planning.

The two fundamental elements of business succession planning – the family and the business – often correspond to two distinct aspects of business succession, namely ownership succession and management succession, respectively. Each aspect requires specialized counseling and guidance. The all-too-common mistake is to place too little attention on management

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[1] Our practice group recommends starting business succession planning when the current owners are in their fifties and at the peak of their success and power, or more generally, approximately ten (10) years in advance of their desired transition date.

succession causing the successful transition of a family business from one generation to the next to be the exception rather than the norm. The focus tends primarily to be on finding the most profitable and tax efficient means of transferring the financial interests and overall control of the company. It is equally as important to devote sufficient time and energy to finding a suitable replacement to manage the day-to-day operations of the company. Put simply, it is crucial to address both ownership succession and management succession, as the former is in jeopardy without the latter. As Amy Braden, former Managing Director of JPMorgan Private Bank's Family Wealth Centre, has observed, "Being the owner of a plane doesn't mean you have the right to fly it, and being the pilot doesn't mean you can decide which routes to fly."[2]

Identifying a suitable successor manager of the business is at the heart of management succession planning. The ultimate goal is to find a potential leader, within or without the family, who can succeed to the current management and leadership and best set the company up for future success. An owner of a family business often wants to keep both ownership and management within the family by "passing the torch," so to speak, down to a member of his or her family. However, it is an unfortunate truism of management succession planning that business acumen cannot, in all cases, be transmitted genetically. It is common, on the one hand, for the current leader or older generation to build the business to its current level of success, only to have the next generation lack the whit, business savvy, skills and intuition to maintain such success in later stages and for later generations. On the other hand, there very well may be a younger member

[2] *Preserving Family Harmony*, JPMorgan Private Bank Portfolio, pp. 14, 18 (Fall 2005).

of the family who, with or without additional education, training and support, is or will become the obvious successor.

In either case, before deciding who might eventually succeed him or her in managing the company, the current manager should take a step back, or rather, a step up, and look at the business and his or her family from a thirty-thousand-foot view. In other words, he or she should take an honest inventory of his or her family by evaluating the competency and potential of any such candidate from an objective standpoint. This is an absolute necessity. If a son or daughter has the desire and, more importantly, the ability to take over and lead, that is great. If he or she does not, and no other family members offer promise, one might look to an employee who has been loyal to the business for many years to determine if he or she has what it takes. If not, it might then be necessary to look outside both the family and the business for a potential successor.

Regardless of who is deemed to be best suited to succeed to management, a management transition plan, equipped with robust policies and procedures, must be put in place to define the contours of the transition from current management to the next. For instance, if a member of the family is chosen as the successor manager, a management transition plan might, and should, set forth objective performance review mechanisms for purposes of enabling continual, objective evaluation and review, anticipating his or her eventual promotion and providing for appropriate compensation. In order to avoid dissension among the ranks, it is often advisable that a member of the family start at the bottom of the business (i.e., entry-level positions) and work his or her way up to management. Perhaps more importantly, at any given level of the business, a family member should be compensated in accordance with and in the same manner as others in that position. It is foolish, for lack of a better word, to assume that one's son or daughter will one day take over simply because he or she is one's son or daughter, both from a business operations perspective and from a business culture perspective. It is far more advisable to put in place a transition plan that encourages those who may one day be working for a child of a founder or previous owner to organically grow to respect such child as a leader, not to mention doing so arguably best enables such child to learn and understand the business as a whole.

In short, the ultimate responsibility of setting up a successor for success down the road lies with the founder, or current management, if leadership has already passed into a successive generation. First and foremost, the current manager should strive to be a good teacher, mentor and role model. He or she should provide opportunities for the successor to grow and develop, open doors and afford the successor a sense of having responsibility and "skin in the game." If a parent of the designated successor, the current leader should prevent, or remove, any hint of entitlement from his or her child. Finally, when the time comes, the current leader should be prepared to move on and let go of the management of the business. The successful implementation of a business succession plan is often plagues by so-called "sticky baton syndrome," where the older generation relinquishes managerial powers and the right to direct the operations and trajectory of the company in theory and on paper, but, in practice, retains control and a disproportionate and undue amount of influence. While perhaps most visible in the final stages of a transition plan, allowing a successor to actually lead, to make decisions, and mistakes, and to learn from those mistakes through experience, is paramount to the continued success of the business and its ability to not only survive, but also, thrive, in the former leader's absence.

II. Ownership Succession Planning

Ownership succession can take many forms, including, without limitation, the following:

- A gift, outright or non-outright, or sale to family during one's lifetime;

- A sale to non-family during one's lifetime;
- A gift or sale upon one's death; or
- A sale to co-owners.[3]

While it is certainly advisable to decide the manner and mechanism by which ownership will transfer from one generation to the next sooner rather than later, careful planning must be done to ensure such transfer is both tax efficient and accommodating of the applicable family's and business's goals.

A. Gift or Sale to Family During Lifetime.

1. *Outright Gifts to Family*

A gift of business interests during life is perhaps the simplest means of transferring ownership outright to successor generations. However, with any transfer of assets in the form of a gift, whether during life or at death, come important tax considerations; most notably, federal (and state) gift and estate tax considerations.[4]

With respect to gifts made during life, Section 2503 of the Internal Revenue Code (hereinafter, the "Code") imposes a tax on the lifetime transfer of property (cash or otherwise) by one individual to another where the donor receives nothing, or less than full consideration, in return. This is true whether the transfer is in trust or otherwise, whether the gift is direct or indirect, and whether the property is real or personal, tangible or intangible, and even where the donor does not specifically intend for the transfer to be a gift.[5] The general rule is that any gift is taxable.

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[3] As provided in an applicable shareholders' agreement or buy-sell agreement.
[4] This paper will focus on federal, and not state, gift and estate taxes, as set forth in I.R.C. §§ 2503 and 2001, respectively.
[5] I.R.C. § 2503(a).

However, Section 2503 provides an exception to this rule, in the form of the annual gift tax exclusion, for gifts with a value less than or equal to the so-called annual exclusion amount. For 2021, the annual exclusion amount is $15,000.[6] In other words, each year a family business owner could make a gift of $15,000 worth of his or her interest in the business to each of his or her children[7] without owing any tax on such gifts, and also, without depleting his or her lifetime estate and gift tax credit (discussed below). This is useful in situations where it is preferable to transfer ownership interests in a business to a successor generation over time, rather than in one single lump-sum transfer. Nevertheless, in most situations, such transfers are generally not worth the time and money it would take to value the business each year. Instead, for most wealthy clients, a cash gift of $15,000 is the best way to take advantage of the annual gift tax exclusion.

With respect to transfers made at death, Section 2001 of the Code imposes a tax on the transfer of the so-called "taxable estate" of every decedent who is a citizen or resident of the United States.[8] However, depending on how generous one was with gifts during his or her lifetime, his or her taxable estate might not owe an estate tax thanks to the so-called "unified credit"[9] against the gift and estate tax. The estate tax credit is set forth in Section 2010 of the Code, which provides that a credit of the "applicable credit amount" shall be allowed to the estate of every decedent against the tax imposed by Section 2001.[10] The applicable credit amount is the amount of the tentative tax which would be determined under Section 2001(c) if the amount with respect to which

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[6] I.R.C. § 2503(b)(1). For gifts made to any person during the calendar year, the first $10,000 (indexed for inflation, $15,000 in 2021) shall not be included in the total amount of gift made during such year. I.R.C. § 2503(b)(2).
[7] The annual gift tax exclusion does not apply only to gifts made to children or family. Under Section 2001 of the Code, gifts of $15,000 of cash or other property may be made to an unlimited number of individuals.
[8] I.R.C. § 2001(a).
[9] Often referred to as such because the applicable credit amount covers both gifts in excess of $15,000 (the annual gift tax exclusion amount) under Section 2505 and the value of the taxable estate under Section 2010. Thus, gifts in excess of the annual gift tax exclusion amount will reduce the amount of credit remaining at death.
[10] I.R.C. § 2010(a).

such tentative tax is to be computed were equal to the "applicable exclusion amount."[11] The applicable exclusion amount is the sum of the basic exclusion amount and, in the case of a surviving spouse, the deceased spousal unused exclusion amount, or DSUE.[12] For 2021, the basic exclusion amount is $11,700,000 per individual. Ultimately, this means that an individual may give away during life or leave at death up to $11,700,000 worth of assets without owing any gift or estate tax. With portability, a married couple, collectively, may give away or leave up to $23,400,000 gift and estate tax-free.

The abnormally high unified credit amount, ushered in by the Tax Cuts and Jobs Act of 2017, enables individuals to move substantial amounts of value and wealth among their family.[13] If done correctly, a transfer that is both part-gift and part-sale can be an effective strategy for enhancing the benefits of the transfer of wealth from one generation to the next. In many instances, the goal is to take advantage of the above-referenced tax credits in order to move appreciating assets out of an individual's estate and freeze the value of such assets for estate tax purposes.

If a family business owner desires to transfer ownership in the business to his or her family during his or her lifetime, he or she must first evaluate his or her family, particularly the children, and decide how such ownership will be divided among the next generation. Should ownership be divided equally? Should the economic rights and the control (i.e., voting) rights be treated differently? For example, if one child is working, or plans to one day work, in the business while the other(s) is not, should such participating child be afforded greater control in the form of more voting rights? In that case, it might be beneficial to provide a means by which the participating children, or the business itself, are able to redeem the shares of the non-participating children.

[11] I.R.C. § 2010(c)(1).
[12] I.R.C. § 2010(c)(2).
[13] Note the increase from the unified credit in 2017 of $5,490,000.

Consider the following example of a family business owner with one son and one daughter, whose ownership succession plan might operate as follows:

> The son works in the business; the daughter does not. The economic rights in the business are split equally among the two children, but the control rights in the business are not. The son has one more voting share than the daughter. This enables the son, who is active in the business, to make business decisions, whether related to the management thereof or a liquidation event, without having to consult the daughter, who is not active in the business. Upon the son's death, his one additional voting share will be converted to non-voting so that, moving forward, in the event the daughter survives the son, the daughter and the son's estate will be equal shareholders, both in terms of economic rights and control rights. With no member of the successor generation being active in the business, any decision regarding a liquidation event (i.e., whether to sell the business to a third party or to continue the business under family ownership) must be made in unison.

The division of ownership at the next level is a sensitive and difficult, but nonetheless important, decision to make. As with management succession planning, ownership succession planning often requires family business owners to honestly and objectively analyze his or her children's personal and business-related strengths and weaknesses. And it's important to remember that ownership succession planning, like management succession planning, has its own unfortunate truism: fair is not equal and equal is not fair.

A sale in return for a promissory note is another useful vehicle for transferring ownership outright to a successor generation. Presently low interest rates make such vehicle even more attractive and powerful. Using the current long-term Applicable Federal Rates (hereinafter, the "AFR")[14] for September 2021 as an example, a family business owner could structure a sale of his or her interest in the business to a child so that the child pays a relatively *de minimus* cash down payment and executes a promissory note in favor of the business owner parent with a 30 year term

[14] The AFR is published on a monthly basis on the IRS' website. https://apps.irs.gov/app/picklist/list/federalRates.html

and an interest rate of 1.73%.[15] In this example, the child could then pay the interest on the note using distributions and/or dividends from the business, and, upon his or her death, the business owner parent could forgive any then-outstanding debt amount. For intra-family loans such as this, the forgiven then-outstanding debt amount is not considered a discharge of indebtedness income attributable to the child; rather, such forgiveness is considered a gift or bequest to the child, to which the forgiving family business owner (or, more accurately, his or her personal representative) may apply his or her remaining unified credit.

2. *Non-Outright[16] Gifts and Sales to Family*

If an outright transfer is not desirable, significant tax efficiencies can be achieved by making gifts of business interests in trust or by selling business interests to a trust. For example, business interests may be sold to a so-called "grantor trust," also known as an "intentionally defective grantor trust."[17] A sale to grantor trust is a sophisticated business succession planning strategy that can provide substantial benefits to family business owners seeking to transfer assets to a successor generation while minimizing income, estate and gift tax liabilities.[18] "Grantor trust" status is an income tax classification which causes the income, losses, gains, deductions and credits of any qualifying trust to be taxable to the trust's grantor (or creator), rather than to the trust itself, without causing the underlying assets to be includible in the grantor's estate.[19] In other words, if

[15] While a family business owner might be inclined to not charge his or her child interest on any such promissory note, doing so could have unintended tax consequences. Section 7872 of the Code requires that for a loan exceeding $10,000, an interest rate of at least the AFR must be used. I.R.C. § 7872(c)(2).
[16] Meaning, in trust.
[17] That is, "defective" for income tax purposes, but "effective" for estate tax purposes.
[18] A sale to a grantor trust is particularly effective for family or closely-held businesses which have elected to be taxed as a S corporation pursuant to Section 1362(a) of the Code, since, under Section 1361(c)(2)(A)(i), grantor trusts are eligible holders of interests in a business that has elected S corporation status.
[19] I.R.C. §§ 671 – 679.

structured properly, the grantor trust and the assets therein will be excluded from the grantor's estate for estate tax purposes and attributable to the grantor for income tax purposes.

Nearly every trust is capable of being classified as a grantor trust.[20] So long as the grantor retains certain powers over the trust, as described in Sections 671 through 679 of the Code, he or she will be considered the "owner" of the trust for income tax purposes, and thus, will be responsible for the income, losses, gains, deductions and credits attributable to the trust. The following are some of the powers that must be retained by the grantor in order to qualify a trust as a grantor trust:

- The power to exchange, sell or otherwise deal with trust assets for less than adequate consideration;
- The power to borrow from the trust without adequate security;
- The power to control the investment of the funds of the trust; and
- The power to reacquire trust assets by substituting other assets of equal value.[21]

A natural reaction to learning of grantor trusts might be to wonder why one would ever actively seek out grantor trust status. Why would a family business owner want to pay income tax on the business interests that he or she no longer owns after transferring it to a trust for the benefit of his or her children? The answer is three-fold and relates, primarily, to the income tax and estate tax benefits associated with the sale of one's business interests to a grantor trust.[22] First, if structured properly as set forth above, selling one's business interests to a grantor trust allows such

[20] For purposes of this discussion, we will focus on irrevocable grantor trusts.
[21] I.R.C. § 675. Such powers, which afford the grantor some measure of control over the trust, fall short of the level of control necessary to cause inclusion of the trust's assets in the grantor's taxable estate under Section 2036 of the Code (relating to retained life estates).
[22] There are no gift tax-related benefits associated with a transfer to a grantor trust, so a gift to a grantor trust would still be subject to gift tax.

person to transfer such interests to a trust for the benefit of his or her children without incurring any income tax or capital gains tax on such sale.[23] Because the grantor is treated as the owner of the trust for income tax purposes, any sale, exchange or other transfer of an asset to such trust does not qualify as an income tax recognition event. Second, the grantor's payment of any income tax attributable to the trust, which does not constitute a taxable gift, enables the trust assets to grow and appreciate in a tax-free environment. Finally, as with any completed gift to a trust, transferring interests to a grantor trust effectively depletes the grantor owner's estate by shifting the value of such interests in excess of the purchase price and any future appreciation out of the grantor's estate for estate tax purposes.

Structuring a sale to a grantor trust in return for a promissory note can also be highly effective in terms of income and estate tax benefits. This technique involves a family business owner (i.e., the grantor) funding a grantor trust for the benefit of his or her children. The grantor would then sell the desired portion or all of his or her business interest to the trust in return for a promissory note with favorable terms (keeping in mind tax consequences discussed above). Since the grantor is treated as the owner of the trust for income tax purposes, he or she will not recognize any gain upon the sale of such interests to the trust.[24] The trust may use distributions or dividends from the business to pay the interest on the note, but the trust must also be funded initially with enough assets to provide a cushion of equity to support the note. [25] Meanwhile, the grantor will

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[23] Rev. Rul. 85-13, 1985-1 C.B. 184 ("transaction cannot be recognized as a sale for [. . .] income tax purposes if the same person is treated as owning the purported consideration both before and after the transaction" *citing Dobson v. Comm.*, 1 B.T.A. 1082 (1925)).

[24] *See* Rev. Rul. 85-13, *supra* note 22.

[25] This cushion of equity could help prevent unwanted scrutiny from the Internal Revenue Service ("IRS"), which, in the event of a sale to a grantor trust, and particularly one involving a right to receive payments under a promissory note, may attempt to bring the value of such assets on the date of the death of the grantor into the grantor's taxable estate, arguing that the grantor's retained right to receive payments under the note is a retained interest under Section 2036 of the Code. Many practitioners contend that a grantor trust should be funded with at least 10% of the value of the assets being sold to the trust in order to provide sufficient cushion. The source of this appears to be a conversation that Byrle Abbin had with the IRS while in the process of obtaining Ltr. Rul. 9535026. Of course the transfer of such so-called "seed money" to the trust is a taxable gift to which one's unified credit must be applied, or otherwise, on which gift tax must be paid.

receive payments of principal and interest from the trust during the term of the note, but he or she would not incur any income tax liability, since the receipt of such payments would be ignored for income tax purposes.[26]

A second trust to which a family or closely-held business owner might consider transferring some of his or her interests is a so-called "grantor retained annuity trust" ("GRAT"). GRATs, which are products of Section 2702 of the Code, are generally viewed as "safe" estate planning techniques, provided all the prescribed statutory requirements are met and respected throughout the term of the GRAT.[27] A transfer to a GRAT is an extremely useful ownership succession planning tool for transferring appreciating assets out of an individual's estate and freezing the value of such assets for estate tax purposes. As a result, the type of assets involved in transfers to GRATS often include business interests and other similar assets which generate income and have substantial value and appreciation potential.

In a transfer involving a GRAT, the grantor transfers assets to an irrevocable trust in return for the right to receive annuity payments each year for the term of the trust. More specifically, the grantor will receive, for a specified term of years,[28] fixed payments (which may be expressed as a dollar amount or as a percentage of the initial fair market value of the trust) on at least an annual basis based upon the initial fair market value of property and using an interest rate determined by the IRS on a monthly basis called the "section 7520 rate" then in effect. Although the assets held in the trust may increase in value during the term of the GRAT, the fixed annuity amount will not

[26] *Id*.
[27] *See* I.R.C. § 2702.
[28] Two or three years is most common, as the shorter term (1) takes advantage of the volatility of the value of the transferred assets and (2) minimizes the risk of the grantor dying prior to the end of the term.

change. Upon the expiration of the annuity term, the trust assets will pass to the beneficiaries of the trust, either outright or in further trust.

The transfer of assets owned by one person into an irrevocable trust for the benefit of another person would ordinarily be deemed a gift for gift tax purposes. However, the imposition of gift tax on a transfer to a GRAT may be all but avoided by using what is known as a "zeroed-out GRAT."[29] With a zeroed-out GRAT, the grantor can set the annuity payment so that it will equal the section 7520 rate. By doing so, all the assets that the Grantor transfers into the GRAT will be returned to him or her in the form of annuity payments over the term of the GRAT so that, in theory, no real gift is made. In other words, there should be nothing remaining in the GRAT for distribution to the beneficiaries thereof upon the termination of the GRAT. Since virtually all the assets transferred to the GRAT return to the grantor, the value of the gift to the beneficiaries should be at, or close, to zero; hence, the zeroed-out GRAT.

Like the reaction of learning of grantor trusts above, one might readily ask why it would ever make sense to transfer assets to a trust for the benefit of another person if the assets are essentially returned to the grantor in the form of annuity payments. The answer lies within the type of assets generally used to fund GRATs, which, as noted above, typically include appreciating assets like closely-held business interests. By using a GRAT to transfer wealth to a successor generation, the family business owner is essentially betting that the business interests transferred to the trust will appreciate above and beyond the section 7520 rate, on which the annuity payments

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[29] We write "all but avoided" because the IRS generally holds the position that assets may not be transferred to a GRAT with no tax consequences, largely because there is always the possibility that the grantor may die during the term of the GRAT. However, while there is in fact a tax consequence of the transfer of the initial transfer of assets to the GRAT, the GRAT may be structured in a way for such tax consequence to be negligible by using a zeroed-out GRAT. Our practice group recommends following *Walton v. Comm.*, 115 T.C. 589 (2000), where the grantor, Audrey Walton, widow of Bud Walton, paid approximately $6,000 in gift tax upon the transfer of $100 million of Wal-Mart stock to two GRATs, one for the benefit of each of her daughters.

are based. If the underlying assets do so, they, along with the appreciation over the section 7520 rate, will pass upon termination of the GRAT to the remainder beneficiaries free of gift tax.

Thus, with a GRAT, a family business owner would transfer his or her interest in the business to GRAT for the benefit of his or her children, but the owner would retain the right to receive a fixed amount for a certain number of years. As mentioned, the valuation of the gift would be determined based upon the remainder value of the property transferred into the GRAT, which, if structured properly, should be zero (or nearly zero). The GRAT would then own the business interests, and the trustee would be required to must make annuity payments to the owner in accordance with the governing instrument. Payments could be made monthly, quarterly, semi-annually, or annually. It is important to note that if the income of the assets in the GRAT is in excess of the retained annuity amount, the GRAT could provide that the difference be distributed to the owner. However, this would only increase the owner's estate and provide minimal benefit, if any.[30] Upon termination of the GRAT, the owner, in theory, would have received back the initial value of the interest in the form of the annuity payments, and, most importantly, the assets and the appreciation thereon over the section 7520 rate during the term of the trust would pass free of gift tax to the owner's children.

As can be seen, GRATs provide significant tax benefits, most notably, (i) the negligible gift tax resulting from valuing of the gift based on the actuarial value of the remainder interest and not on the value of the annuity payment, and (ii) the ability for any future appreciation of the assets transferred to the trust passing virtually tax free. However, there are downsides and risks associated with using GRATs to facilitate family wealth transfers. For example, by transferring

[30] This may be helpful where the grantor needs extra cash to help alleviate the pain of paying the income taxes attributable to the GRAT.

assets to a GRAT, there will be no step-up in the basis of the transferred assets at the death of the grantor. The transferred assets might otherwise fail to generate enough cash and income to pay the annuity amount.[31] Finally, and perhaps most importantly, there is the risk that the grantor dies during the term of the GRAT, in which case a portion of the value of the assets that were transferred to the GRAT would be included in the grantor's estate for estate tax purposes.[32]

In thinking about transfers of family or closely-held business interests, particularly of those businesses electing to be taxed as an S corporation, to trusts, one must be careful to ensure that a recipient trust is an eligible holder of S corporation interests under Section 1361 of the Code. Transferring interests in an entity that has elected to be taxed as an S corporation to a trust that is not an eligible holder risks losing the S election. Other than individuals who are U.S. citizens or permanent residents,[33] we note three additional eligible holders of interests in a business electing to be taxed as an S corporation: (1) grantor trusts,[34] (2) qualified subchapter S trusts ("QSSTs"), and (3) electing small business trusts ("ESBTs").[35]

A QSST must distribute all income to a beneficiary who is a U.S. citizen or permanent resident.[36] During the life of the beneficiary, the beneficiary must be the only income beneficiary of the trust.[37] Although the trust need not distribute trust principal to the beneficiary, the trust cannot distribute principal to any other beneficiary during the beneficiary's life.[38] On termination

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[31] In such an event, the annuity must be paid in-kind. This creates a valuation issue and a risk that the trust overpays or underpays the annuity, which would, for lack of a better word, "blow-up" the GRAT.
[32] Although beyond the scope of this paper, there are many ways to minimize this impact and qualify the assets for the marital deduction under Section 2056 of the Code. *See* Blattmachr, Slade, and Zeydel, 836-2nd T.M., Partial Interests – GRATs, GRUTs, QPRTs (Section 2702).
[33] Other eligible holders include estates, certain other trusts and certain charitable organizations, as set forth in I.R.C. § 1361.
[34] Note that once the grantor of a grantor trust dies, the grantor trust will only qualify as an S corporation shareholder for two years from the grantor's death, so plans should be made to qualify such trust as an ESBT or a QSST if one wishes to keep the assets in trust. I.R.C. § 1361(c)(2)(A)(ii).
[35] *See generally* I.R.C. § 1361.
[36] I.R.C. § 1361(d)(3)(B).
[37] I.R.C. § 1361(d)(3)(A)(i).
[38] I.R.C. § 1361(d)(3)(A)(ii).

of the QSST, all QSST principal and income must be distributed to the beneficiary.[39] Meanwhile, an ESBT, which has more flexible requirements than that of QSST, is a trust for beneficiaries that are all eligible holders of S corporation interests that acquired their interest in the trust by lifetime gifts or upon the death of an owner of such interest.[40]

B. *Gift or Sale at Death*

It goes without saying that the best time to plan for a gift or sale of business interests upon the death of the family business owner is during the owner's lifetime. The simplest and most common means of providing for the disposition of business interests is in one's will or other testamentary documents (e.g., a revocable trust), subject to any buy-sell or shareholders' agreement (discussed below). If a family business owner desires for the actual business itself to remain in the family, he or she might consider including a specific bequest of his or her interests to his or her children in the will. As with a transfer to family during life, it is important for the family business owner to determine how both the economic right and the control right associated with the business will pass upon his or her death. For example, the will could provide that the owner's interest in the business will pass in equal shares to his or her children if all are involved in the business, or, if some children are involved in the business and others are not, the owner again might consider treating the disposition of the voting shares and the non-voting shares differently. Note, however, that in order to provide for the latter, the business will need to be structured, or restructured, during the owner's lifetime to provide for two classes of ownership interests.

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[39] I.R.C. § 1361(d)(3)(A)(iv).
[40] I.R.C. § 1361(e)(1)(A).

Another option for dealing with participating and non-participating children is leaving all of the business interests to the participating children and leaving other assets (e.g., cash, brokerage accounts, real estate) of equal value to the non-participating children. If a family business constitutes the bulk of the estate, it might be useful to consider purchasing a life insurance policy on the owner's life, of which the non-participating children are the beneficiaries, to fund such non-participating children's inheritance. Be careful, though, as this manner of divvying up one's estate may have unforeseen consequences down the road. For example, consider a family business owner whose family business comprises the majority of his estate. The owner has one daughter, who participates in the business, and one son, who does not participate in the business. In effort to affect his business succession plan, the owner makes a lifetime gift all of his interest in the business to his daughter (taking advantage of his remaining unified credit amount). Meanwhile, the owner purchases an insurance policy on his life, the proceeds of which will be paid out to his son, and executes a will disposing of the remainder of his estate equally between the son and the daughter. Assume that, as time goes on, the business in question begins to decline, substantially diminishing the value of the business interests now owned by the daughter. Assume further that the owner's will is never updated to ensure that the owner's estate is divided equally between the two children, taking into account gifts during life. As a result, upon the death of the owner, the son, who is to receive the death proceeds of the large insurance policy, will ultimately receive far more value a than the daughter, who is left with less valuable interests in the company.

Nevertheless, allowing one's assets to pass at death provides additional options and tax benefits in the future for the beneficiaries of such assets. For instance, unlike assets passing to the beneficiaries of a GRAT upon its termination, assets passing the beneficiaries of one's estate upon the testator's death receive a full step-up in income tax basis. Section 1014(a)(1) of the Code provides that the basis of property in the hands of a person acquiring the property from a decedent is the fair market value of the property at the date of the decedent's death.[41] Thus, if, upon receipt of property via will, a beneficiary desires to sell or otherwise dispose of such property soon thereafter, the taxable gain therefrom will likely be close to zero, since the amount realized from the sale of the property will equal his or her adjusted income tax basis in the property.[42]

A final, but no less important, consideration to discuss in the context of a gift or sale of a business interest at death is the valuation of such interest for gift and estate tax purposes. The general valuation for gift and estate tax purposes is the "fair market value" of the gift property as of the date of the gift or death, respectively. "Fair market value" is defined by the regulations as the price at which the property would change hands between a willing buyer and a willing seller, neither of whom is under any compulsion to buy or to sell, and both having reasonable knowledge of relevant facts.[43] The valuation principles applicable to business interests included in estates for estate tax purposes are similar, but not identical, to those applicable to gifts.[44] In addition to the provisions of the Code and the regulations promulgated thereunder, Rev. Rul. 59-60, 1959-1 C.B. 237,[45] sets forth various factors to be considered in valuing interests in closely held corporations (and other business entities)[46] for purposes of the gift and estate taxes. The ruling outlines the general approach to be followed in valuing the stock, and it contains a discussion of the following relevant factors:

- The nature of the business and the history of the enterprise from its inception;

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[41] I.R.C. § 1014(a)(1).
[42] *See* I.R.C. § 1001(a).
[43] I.R.C. Reg. § 25.2512-1.
[44] I.R.C. Reg. § 20.2031-3.
[45] M*odified by* Rev. Rul. 65-193, 1965-2 C.B. 370, *amplified by* Rev. Rul. 77-287, 1977-2 C.B. 319, *amplified by* Rev. Rul. 80-213, 1980-2 C.B. 101, *amplified by* Rev. Rul. 83-120, 1983-2 C.B. 170.
[46] *See* Rev. Rul. 68-609, 1968-2 C.B. 327 regarding the applicability of Rev. Rul. 59-60 to other business interests.

- The economic outlook in general and the condition and outlook of the specific industry;
- The book value of the stock and the financial condition of the business;
- The earning capacity of the company;
- The dividend-paying capacity of the company;
- Whether the enterprise has goodwill or other intangible value;
- Sales of the stock and the size of the block of stock to be valued; and
- The market price of stocks of corporations engaged in the same or a similar line of business having their stocks actively traded in a free and open market, either on an exchange or over the counter.

In the context of closely-held, non-publicly traded businesses, it is also common for certain discounts to apply, namely, discounts for lack of control (i.e., minority interest) and for lack of marketability. Conversely, a premium might be applied in the case of controlling interest. Typically, a discount also is available in valuing nonvoting shares. The valuation of business interests generally considers any restrictions to which the interests are subject, such as those found in an applicable buy-sell or shareholders' agreements (discussed below). These considerations, as well as other special valuation rules set forth in Chapter 14 of the Internal Revenue Code,[47] can have a significant effect on the valuation of closely-held business interests that are transferred to family members, particularly upon death.

Consider the scenario where a successful and highly valued (far in excess of the $11,400,000 estate exemption) family business, which is set to pass in equal shares to the children of the owner, constitutes the overwhelming majority of the owner's estate. In other words, the

[47] I.R.C. §§ 2701–2704.

owner's estate is rather illiquid. Assume that, upon the owner's death, his or her estate owes a large tax bill based on the value of the business but has insufficient cash or liquid assets to cover the tax. Fortunately, the IRS contemplated this exact situation.

When an estate includes interests in a closely-held business, the executor of the estate generally has the choice of paying the estate tax attributable to the business in a lump-sum within nine months of the decedent's death or in installments over a period of years.[48] However, for qualifying estates, Section 6166 of the Code enables executors to elect to defer payment of that portion of the estate tax which represents such qualifying business.[49] If the executor so elects, the estate tax may be payable in annual installments ranging from two to ten years, with the first installment due five years after the original due date of the tax (i.e., nine months after the decedent's death).[50] As a result, payment of any estate tax attributable to a qualifying closely-held business may be deferred for up to a maximum of fourteen years from the original due date by paying the first installment at the end of year five and paying the remainder in annual installments in each of the succeeding nine years. In essence, the installment plan set forth in Section 6166 may be thought of as a 5-year deferral coupled with a 10-year installment payment.

The executor of an estate which owns interests in a closely held business may take advantage of the Section 6166 installment plan if the decedent's interest in such business at the time of his or her death constituted more than 35% of his or her adjusted gross estate.[51] Ownership interests in multiple closely-held businesses may be used to satisfy the 35% test as long as the value of the decedent's interest in each business is at least 20% of the total value of the business

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[48] I.R.C. §§ 6075(a) and 6159(a).
[49] *See* I.R.C. § 6166(a)(1).
[50] *Id.*
[51] *Id.*

at the time of decedent's death, and no single business has more than 45 partners or shareholders.[52] As noted, taking advantage of the Section 6166 installment payment of estate taxes is helpful to those estates comprised of illiquid interests in closely-held businesses and few other liquid assets; otherwise, the estate might be forced to sell the interests in the business for a sizeable discount.

C. *Sales to Non-Family Co-Owners*

Although the means of doing so can be complicated, individuals who own their own business individually can prepare and implement their business succession plans via thorough estate planning documents. The consequences of disability may be addressed by nominating an agent under a durable power of attorney or a successor trustee to a revocable trust, where such fiduciary is able to make financial decisions on the principal’s or grantor’s behalf, including those involving a family business. Divorce may be addressed through pre- and post-nuptial agreements. One’s own departure or relinquishment of a family business may be addressed by simply making a gift of or selling one’s interest in the business.

However, when it comes to businesses co-owned by multiple individuals, particularly unrelated parties, the complexities embedded within each of the events described above are enhanced. One owner must not only consider his or her own family in making decisions related to business succession planning, but also, how any such decision will impact the non-family co-owners of the business. In many cases, the smoothest route forward, and one often required by typical buy-sell and shareholders’ agreements (discussed below), might be through a buy-out of the affected, non-family co-owner(s) at a predetermined price. Any such buy-out may be

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[52] *See* I.R.C. § 6166(b).

accomplished via a "redemption," where the business itself is the purchaser, or a "cross-purchase," where the remaining co-owners are the purchasers.

Buy-sell and shareholders' agreements (collectively, "buy-sell agreement") are at the crux of succession planning when it comes to closely-held businesses with multiple non-family co-owners. These agreements are crucial to the success of co-owned business succession planning, as they establish when, to whom and at what price an owner, partner or shareholder can or will sell his or her interest in a business. Specifically, a buy-sell agreement is a contractual arrangement between the owners of a business, and perhaps the business itself, that restricts the transfer of ownership interests in such business by providing for specified options or obligations to purchase an owner's interest upon the occurrence of certain specified "triggering events." The basic events that might trigger the sale of an owner's interest in an entity include the following:

- Receipt of bona fide offer from a third party;
- Death;
- Involuntary transfer;
- Disability;
- Cessation of employment; and
- Failure to qualify as an S corporation shareholder.

Buy-sell agreements can be structured as separate stand-alone agreements, as is common with corporations, or incorporated into the company's operating agreement, as is common with partnerships and limited liability companies.

The primary purpose of a buy-sell agreement is to restrict the transferability of ownership interests in the business. Accordingly, a provision providing exactly that should be included. For example, it might be helpful to include a single provision stating that the parties to the agreement agree that the owners will not "sell, transfer, encumber, pledge, assign, gift, bequeath or otherwise dispose of" any of the now-owned or after-acquired ownership interests in the business, whether voluntarily, involuntarily or by operation of law, except in accordance with the terms of the buy-sell agreement. Any transfer in violation thereof, and not otherwise permitted by the terms of the agreement, would be void. If the ownership interests are evidenced by certificates, such as stock certificates of a corporation, such restrictive language should be included such certificates in the form of a legend. Although a general restriction on the transfer of interests is recommended, so-called "permitted transfers" may be allowed, for example, for transfers to another owner, an affiliate of an owner, a member of an owner's family or a trust for the benefit of a member of an owner's family (keeping in mind the rules for trusts owning S corporation interests).

In addition to specifying the events which trigger the acquisition of an owner's interest in the business and who has the option or obligation to purchase upon the occurrence of such an event, it is advisable to state at what price the interests will be purchased. For example, the agreement may simply state that the purchase price shall be the fair market value of the interest in question as determined by a qualified appraisal as of the date of the triggering event. Other options include establishing the value of the business by agreement of the owners on an annual basis, by a determination by the business' certified public accountant or by the income multiplier method (discussed below).

Consider also how the purchase price will be paid. A single, lump-sum payment of the purchase might cause cash flow problems for the purchaser. Therefore, it is often desirable to make the purchase price payable over time. For example, the sale may be structured so that a percentage of the purchase price, or a specified dollar amount, is payable upon closing with a promissory note for the remainder, where the remaining balance, and interest thereon, is paid in periodic installments over a period of time. Funding the purchase of an owner's interest with a life insurance policy on the life of such owner is another tool for easing the cash flow impact on the purchaser.

The following is a brief list of provisions which are typically included in buy-sell agreements:

- Put/Call Transfer: an owner could at any time submit an offer to the other owners to sell all the interests owned by such initiating owner to the other owners, including the type and value of the consideration and terms of payment at which the initiating owner would be willing to sell his or her interests in the business. The other owners would have the option to either (i) purchase the interests of the initiating owner on the terms and conditions described in the offer, or, in the alternative, (ii) sell to the initiating owner not less than all of the other owner's interests on the terms and conditions stated in the offer.

- Rights of First Refusal upon Death: upon the death of an owner, the business, otherwise the remaining owners would have the right and option, or obligation, to purchase from the deceased's owner's personal representative all the interests owned by the deceased owner.

- Rights of First Refusal upon Involuntary Transfer: if, other than by reason of death, all or any of the interests owned by an owner become subject to transfer by operation of law to any person other than the business or any of the remaining owners (such as by transfer to a trustee in bankruptcy, a purchaser at any creditor's or court sale, a spouse or former spouse of the owner in a divorce settlement or decree, or the guardian or conservator of the owner), such attempted or purported transfer would be treated as null and void, and the business, otherwise the remaining owners, would purchase all the interests of the divesting owner.

- Rights of First Refusal upon Bona Fide Third Party Offer: if any owner receives from a third party a bona fide offer to purchase all of his or her interest and such owner desires to sell his or her interests on the terms contained in such offer, then the business, otherwise the remaining owners, would have the right and option, but not the obligation, to purchase all, but not less than all, of the interests of such owner at the same price and upon the same terms and conditions as are contained in the offer from such third party.

Understandably, the sale of one's business requires the consideration of numerous factors, variables and issues. While we do not endeavor to address all such factors, variables and issues in this paper, given the context, a few of such factors, variables and issues are worth addressing. First, locate the right buyer. Potential buyers include competitors, senior management within the company, employees and private equity firms. Business brokers who specialize in specific industries are often available to assist with locating potential buyers. Second, decide what consideration will be received in the sale: cash, interests in the acquiring company, a combination of both, or a combination of cash and a promissory note. Each approach, as discussed herein, carries with it certain advantages, disadvantages, risks and tax consequences.

In terms of tax consequences, consider whether, under the circumstances, a direct sale, a sale for stock, an installment sale or some other mechanism is appropriate. For example, a direct cash sale will almost certainly result in present taxation of any capital gain resulting therefrom, while a sale for stock can be structured to defer any taxation until the newly acquired stock is sold for a gain at a future date. The selling owner must also consider whether, after any such sale, he or she desires to have continued involvement with the business. Often, buyers will require, or at least, request, that the selling party stay involved with the management and operations of the business, or otherwise, execute a non-compete agreement. One option to consider is staying involved as a consultant for a set period of time and for set compensation.

Lastly comes the value at which the business will be sold, perhaps the most important of all factors, variables and issues associated with selling one's business. As discussed in detail above, valuation is always a key component in business succession planning, whether in the context of a gift, a sale or transfer upon death. Whether it is in the context of a purchase pursuant to a buy-sell agreement, a gifting strategy or a sale to a third party, proper valuation of the business is critical to both the financial and tax ramifications of such transactions. In an arms-length sale, the valuation of business interests is heavily affected by market conditions, accretive effect and demonstrative evidence of value. Although there are several valuation methodologies that can be applied, the most commonly utilized, and often the most effective, is the income multiplier method.

The income multiplier method utilizes a formula where a multiple is applied to the profit of the business (e.g., three times net income). The two critical factors to arrive at a prospective purchase price are (a) what multiple should be used and (b) to what number should the multiple be applied. Determining the appropriate base for a business can be challenging. In some industries, straight net income is an appropriate base, while in others earnings before interest taxes, depreciation and amortization (EBITDA) is an appropriate base. Once the appropriate base has been determined, the next task is to determine the actual number. In closely-held or family-owned businesses, there are often a number of adjustments, commonly referred to as "add-backs", which must be made to determine how much profit the business is actually earning. Finally, the appropriate multiple must be identified. Most industries have sufficient historical data to support a fairly tight range of multiples. The exact multiple used in calculating the purchase price is usually a function of that range, any accretive effect and the negotiation efforts of the seller and the purchaser.

III. <u>Conclusion</u>.

A properly crafted business succession plan can provide substantial benefits to wealthy individuals and families whose estate and wealth is comprised of a family or closely-held businesses and who desire to transfer interests in such businesses from one generation to the next. With the numerous factors, variables and issues, whether they be personal, financial, tax-related or some combination of the three, involved in developing a business succession plan, the current ownership generation should strive to implement, as soon as possible, a succession plan that provides both stability and flexibility in the wake of unforeseen life and business events.