

Non-Tax Aspects of Business Succession Planning

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I. INTRODUCTION

- A. Importance of Family Businesses. More than 90% of the business enterprises in the United States are family dominated. Family-owned and family-managed businesses account for 50% of the nation's employment and 50% of its GNP.

- B. Statistical Probabilities of Succession Failures. Family businesses are at great risk in the generational transfer process. Widely-cited statistics indicate only 30% of these firms survive into the second generation of family ownership, and just 15% survive into the third generation. A recent study cited three reasons why family businesses fail:
 - 1. In 60% of the cases, the failure is attributable to how successor family members interact.
 - 2. In 25% of the cases, the failure is attributable to heirs not being prepared to manage.
 - 3. In 10% of the cases, the failure is attributable to estate and gift taxation which imposes taxes on the transfer of a business. Interestingly, in Australia, which imposes no estate tax, the rate of failure for family business is identical to the failure rate for U.S. family businesses.

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II. FAMILY BUSINESSES ARE DIFFERENT

A. Characteristics of Business Owner. Individuals who have created successful family businesses tend to share similar characteristics. These characteristics are responsible for the success of the business, but can also create an impediment for the formulation and implementation of a successful business succession plan. Michael D. Allen in *Motivating the Business Owner to Act*, ALI-ABA CLE Course of Study: Estate Planning for the Family Business Owner, August 10, 2000 (hereinafter, “Michael Allen”) identifies a number of these characteristics:

1. **Domineering Personality.** Most business owners have strong personalities and insist on remaining in control. Succession planning is often perceived as a threat to control.
2. **Inseparable from Business.** The business is often the owner’s life work. Owners tend to have few outside interests. Few can imagine a life separate from the business. They wonder what they would do if they were to cut back.
3. **Self Esteem Tied to Position.** A business owner’s self esteem is often tied to the position of being in charge of the family business. He or she perceives that community image is reliant on position. Stepping down can be perceived as a loss of significance.
4. **Lacks Independent Financial Resources.** The business often represents the bulk of the owner’s wealth. Older generation members may be dependent (or at least perceive themselves as dependent) on business cash flow to continue their lifestyles.
5. **Has Immortality Complex.** Most business owners believe they can and should remain in charge for years to come. They consider succession discussions premature.
6. **Is Blind to Festering Problems.** While an owner is on the scene, the conditions in and among successors that will eventually produce problems may appear innocuous. The owner’s presence tends to mask their destructive potential, or it may telegraph a perpetual “stop that” to conflict. As a result, well-intended owners may not foresee underlying problems.
7. **Perceives Children As Childlike.** It is very difficult for parents to change their perceptions of a child as childlike. “How can a child effectively run this business?”
8. **Fears Opening Pandora’s Box.** Many owners are aware that problems exist among heirs which have the potential of being very destructive, but they prefer to avoid the problems. “I imagine they will fight like hell after I die, but I won’t live to see it.”
9. **On the Issue of Succession, Operates in a Mood of Resignation.** Successful owners create businesses in moods of optimism and ambition... “Life holds many possibilities.” Ironically, although owners have typically operated in a mood of ambition, the issue of succession often

produces in them a negative mood of resignation... “There are no possibilities for me here.” When this happens, the owner’s subconscious defense mechanisms say, “I don’t want to mess with succession issues now.”

B. **Other Family Members.** It is important to consider the role of other family members in the business succession plan. The business owner’s perception to and relationship with these individuals will greatly influence the success and outcome of the succession plan.

1. **Business Owner’s Spouse.** All too often, professional advisors pay too little attention to the business owner’s spouse. In the case of a female spouse, there is a 75% likelihood that she will outlive her husband by 10 years. The spouse may also exert a great deal of emotional influence on the business owner. In addition, the business owner’s children may secretly communicate (or complain) about the business through this spouse. It is imperative to gain his or her support and “buy-in” with respect to any business succession plan.
2. **Sibling Rivalry.** Sibling rivalry is rampant in many family businesses. It is common for the business owner to minimize the rivalry by separating the children by geography or by function. As discussed later, one of the most difficult decisions a parent must make is to choose a successor. The inability of many parents to choose one child over another often leads to the paralysis of many business succession plans.
3. **In-Laws Not Involved In the Business.** Spouses of children not involved in the business are susceptible to misunderstanding and mistrust by the business owner. This may stem from the business owner’s concerns about the child’s marriage and the fear of divorce. In addition, if there is a sibling rivalry within the business, the in-law may side with his or her spouse and against the rival sibling, creating a potentially divisive situation.
4. **In-Laws Involved in the Business.** In-laws involved in the business bear the benefit and burden of being in a family business. In many cases, they are given a good title (Vice President) and ample compensation. Unfortunately, they may be torn between the loyalty to the family and the family business and the desire to achieve in the outside competitive world. The in-law may be looked down upon by family members and viewed as taking advantage of the family corporate welfare.

C. **Family v. Business Distinctions.** The manner by which family businesses and non-family businesses operate differ; it is important for the planner to recognize these differences. These characteristics, identified by Michael Allen, are as follows:

Characteristic	Family Business	Non-Family Business
Focus	Inward: Relationships	Outward: Customers, Markets, Competition
Admittance	Birth or Marriage	Recruitment; Objective Criteria List
Acceptance	Automatic; Unconditional	Merit; Contribution
Reward	Equality	Merit; Contribution; Responsibility
Orientation	Emotional Systems	Analytical Systems
Evaluation	Sublimate to Avoid Controversy and Rejection	Emphasized as Strong Determinant for Salary and Promotion
Education	Individualistic; Interest	Pragmatic; Structured
Change	To Be Avoided; Tradition Thrives	Sought as an Imperative

D. Estate v. Business Planning. The process of estate planning is different from business succession planning. Once again, Michael Allen, has succinctly identified these distinctions:

Characteristic	Estate Planning	Succession Planning
Goal	Minimize Taxation	Minimize Taxation And Preserve Value Of Business
Timing	Short Term – 30 to 90 Days	Long Term Project – Evolves Over Multiple Years
Level of Customization	Standardized; Focused On Selling The Right Tools	Situational Planning Based On Uniqueness Of Family And Business
Inactive and Non Active Members	Non Issue	Critical Issue
Second Generation Commitment	Non Issue	Critical Issue
Business Survivability	Non Issue	Critical Issue
Control	Retention of Control Does Not Need to Jeopardize Estate Plan	Retention of Control Until Death Can Jeopardize Succession Plan
Delegation to Children	Financial Competence	Business and Management Competence
Treatment of Children	Treat Equally	Treat Equitably
Long Term Action	Not Usually Required By Others	Usually Required By Successors

III. OVERCOMING OBSTACLES TO PLANNING

A. Control and Cashflow

1. The business owner will view the process of business succession planning as a threat. They will be concerned about: (1) giving up control over an entity which they have built; and (2) losing a source of income from the business, whether through salary, dividends, distributions, rents, perquisites, or other sources.
2. It is imperative that the planner assures the business owner that they will be able to retain control for as long as they desire, while implementing the plan. In addition, it is important to assure the business owner that they will be secure in their cashflow and personal financial circumstances.
3. The failure to clear these important hurdles is often the death-knell for most business succession plans.

B. Listen to the Client

1. It is important that the planner identify, early in the process, the business owner's motivation to begin the planning process. The planner will need to draw on this initial motivation from time to time, during the planning process, to remind the business owner why: (1) the business succession planning process was started; and (2) it is important.
2. It is also important to read the business owner's mood. The process of succession planning will often create a mood of resignation for the senior business owner. Consequently, the business owner will be more reluctant to act. It is important to create a sense of new possibilities – “Just think how low your handicap will go when you don't have to punch in at the office everyday.”

C. Understand The Business. It is critical to understand the uniqueness of the client's business, to respect the client's “life work,” and to create a succession plan that is uniquely tailored to the business. The goal of a good business succession planning lawyer is listen to the client's goals, objective, concerns, and fears, and develop a plan that achieves his or her goals and objectives without doing harm to the family dynamic or the family business.

D. Give Candid and Honest Advice

1. It is important to give candid advice and to call a spade a spade.

2. Many business owners will want to paint a rosy picture of their family and their business—“We are all just one big happy family.”
3. The reality, in many cases, is that the children do not get along as well as the parent has described. In addition, the non-family employees and managers may resent the children who they feel are unjustly rewarded for the roles in the company which are the by-product of birth, as opposed to merit.
4. Good advisors should not accept pat answers like “We all get along” and should probe more deeply into family relationships and the wishes and desires of each of the members of the family and key non-family managers.

IV. INITIAL PLANNING CONSIDERATIONS

A. Basic Planning—a Safety Net

1. Many successful and wealthy business owners have done little or no estate planning. Many have no wills. Those who do have wills have simple “I Love You” wills that leave assets outright to the surviving spouse, if then living, and then equally to the children.
2. The first order of business is to implement basic estate planning including the use of Wills and/or Revocable Trusts that take advantage of the business owner and spouse’s \$5,340,000 applicable exclusion amount.
3. In addition, the documents may include provisions relating to the retention of business assets in trust. The provisions may authorize or instruct a fiduciary with respect to the operation and management of the business.
4. It may be appropriate to include provisions relating to the retention of S corporation stock in either a Qualified Subchapter S Trust (“QSST”) or an Electing Small Business Trust (“ESBT”).
5. It may be appropriate to fund the shares for children who are active in the business with specific business assets and to provide equalizing distributions of other assets to children who are not active in the business.
6. It may be appropriate to begin liquidity planning and consider the availability of Code § 6166, Code § 303, Code § 2057, and Code § 2032A.
7. In addition, it may be appropriate to consider the use of an irrevocable life insurance trust to provide a source of liquid assets for the payment of estate tax.

B. Re-Structuring Assets and Ownership Among Spouses—*Mellinger*

1. In order to ensure that the trust intended to be funded with the client's \$5.34 million applicable exclusion amount is fully funded, it is common to re-title assets among spouses, to ensure that each spouse has at least \$5.34 million available to fund a "Credit-Shelter"-type trust.
2. A business succession planner should consider the benefits offered by the *Mellinger* case.
 - a. In *Estate of Mellinger v. Commissioner*, 112 T.C. 4 (1999), the Tax Court held that a 27.5% block of stock owned by the decedent should not be aggregated, for valuation purposes, with a 27.5% block of stock held in a QTIP trust created by the decedent's pre-deceased spouse. The Service argued that the two blocks of stock were included in the gross estate and should be aggregated into one 55% block of stock. The Tax Court disagreed.
 - b. The Service had previously lost the *Bonner* case and subsequently lost *Nowell* and *Lopes*. As a result, the Service issued AOD 1999-006 in which it conceded this issue. *Estate of Bonner v. Commissioner*, 84 F.3d 196 (5th Cir. 1996); *Estate of Nowell v. Commissioner*, T.C. Memo 1999-15 (1999); *Estate of Lopes v. Commissioner*, T.C. Memo 1999-225 (1999).
3. Planners should consider creating structures that permit the business owner to give up control for valuation purposes, while effectively retaining control. For example, assume Mom owns 100% of stock of Acme Widgets. Mom gifts 49% of stock to Dad and 2% of stock to Son. Under Rev. Rul. 93-12, since there is no aggregation of ownership, and assuming Mom and Dad get along, Mom will effectively retain control of the company while only owning a minority interest. If Dad dies and leaves his 49% stock in a QTIP trust for the benefit of Mom (with Mom as the Trustee), Mom will control 98% of the stock, but will be treated, at death as owning two 49% minority interests.
4. For a more detailed discussion, see, Aghdami, "Valuation Discount Opportunities After *Mellinger*, *Nowell* and *Lopes*", *Probate & Property*, March/April 2000.

C. Assemble a Team of Advisors

1. Accountant. The use of a competent accountant is an absolute necessity in business succession planning. In many cases, the accountant has a continuing relationship, if for no other reason than because the accountant prepares the annual tax returns and the business' financial statements. Because of the close relationship and because of the accountant's acute understanding of the business, his or her advice always should be sought concerning the appropriateness of a particular plan and particular problem areas.
2. Insurance Advisor. In many instances, the best solution to the liquidity problems that arise in business succession planning is through the use of life insurance. Given the wide variety of

insurance products available, it is critical to identify an insurance advisor who is knowledgeable about the various products available and the appropriateness of the product with respect to the particular business succession and estate plan.

3. **Financial Advisor.** A major goal of business succession planning is continued viability of the business' financial enterprise. As such, it may be necessary to include a financial consultant on the planning team.
4. **Appraiser.** In most instances, the planning team will need to include a competent business appraiser to determine the value of the business, whether it is to be sold or transferred to family members. Given the Tax Court's increasing skepticism and scrutiny of submitted appraisals, the appraiser chosen should be one who has a great deal of experience, especially in tax valuation issues.

See, Koren, Non-Tax Considerations in Family Business Succession Planning—Parts One and Two, Koren Estate and Personal Financial Planning Update, August and September 2002.

- D. **Study the Business.** One component of the Hippocratic Oath, taken by doctors, is “Do No Harm.” It is important for the business succession planner to (1) understand the business; and (2) take no action in connection with the business succession plan that will irreparably harm the business. The planner needs to have a deep understanding of the business, its owners, employees, managers, competitors, revenues, margins, liabilities, strengths and opportunities. The planner should consider the questions, developed by Michael Allen, and listed on Appendix A.
- E. **Study Non-Business Assets.** The importance of non-business assets can be over looked when the primary focus is on the business. Non-business assets play key roles in succession planning. The amount of non-business assets greatly impacts the degree to which owners will give up equity and control. In addition, non-business assets can be used to equalize estates, with non-business assets passing to children who are not active in the business.
- F. **Study Family and Assess Younger Generation's Commitment To The Business**
 1. It is critical to develop a strong understanding of the family, the family dynamics, their financial security, and how they view the planning process.
 2. It is important to identify family members who have particularly strong relationships and family members who have particularly difficult relationships.
 3. In addition, it is important to probe into each child's commitment to the family business and their anticipated future role in the business.

4. It may be worthwhile for the business succession planner to meet with each family member independently and develop a candid report or summary of the family's goals and views with respect to the future of the business.

G. Formulate the Plan

1. Who Gets What? – Fair v. Equal.
2. Satisfy the Cashflow Needs of the Business Owner.
3. Satisfy the Business Owner's Desire for Control.
4. Who is Entitled to Equity in the Business?
5. Who is Entitled to Employment in the Business?
6. Should the Company Be Retained or Sold?

V. FAIR v. EQUAL

A. Introduction

1. Many clients, when asked about how they want their assets to be distributed to their children, will reply either "We want to be fair" or "We want to treat them equally."
2. Probably the first, and most important hurdle, for the business succession planning lawyer, is to get the client to understand that "Fair" does not mean "Equal" and that the goal should be to treat the children "fairly." This will, in all likelihood, mean that the children might not be treated "equally."
3. Many business succession plans are paralyzed by the business owner's unwillingness or inability to accept this harsh reality.

B. Children Are Too Young to Run Business

1. If the children are too young to run the business, the business succession plan should, in all likelihood, focus on two goals:
 - a. Selling the business to an outside third party; or
 - b. Identifying or retaining non-family key management capable of continuing the business until the children are willing and able to run the business.

2. In this context, the fairness is both to family of the deceased business owner and to the employees of the business:
 - a. The children may be ill-prepared and unwilling to go into the family business. They may resent the “forced” career choice and may not have the skills to effectively manage the business enterprise.
 - b. The employees will resent the ill-prepared manager who is destined to run the business into the ground. They may fear losing their jobs as business revenues diminish and opportunities are lost.
3. In the event the business will be retained until the children are willing and able to run it, the succession plan should include some of these components:
 - a. Designation of a management team to run the business;
 - b. An outside Board of Directors; and
 - c. Employment agreements, with appropriate incentives, for key management.

C. Children Can Run Business

1. If one or more of the children can run the business, the business succession planning lawyer should focus his or her efforts on shifting the family business to the children at the lowest transfer tax cost, while keeping the business owner reasonably comfortable in retirement.
2. Many of the wealth transfer techniques discussed at this conference can be applied in this context.

D. Only One Child In Business—What About the Others?

1. In many family businesses, there may be a child who is active in the business and others who are not. The “fair v. equal” conundrum arises most often in this context.
2. If there are sufficient other assets in the business owner’s estate (outside the value of the business), the business owner may be able to leave the business assets to the child who is active in the business and leave assets of an equivalent value to the children who are not active in the business. Everyone is treated fairly and the child who is active in the business can operate the business without interference.
3. If there are insufficient non-business assets in the estate to make an equitable distribution of assets, it may be appropriate to separate non-operating assets, such as real estate, from the

business. The non-operating assets could be given to the children who are not active in the business, subject to the terms of a lease or other agreement with business. In addition, the child who is active in the business may be required to buy out the interests of his or her siblings who are not active in the business. These requirements should be dictated by the parent and not left up to the children.

E. Multiple Children in Business

1. Where multiple children are involved in the business, family rivalry and personal dynamics exacerbate the internal stresses and competition typically found in a non-family business.
2. In most cases, a business needs one leader. Consequently, it is preferable to give control to one child. This is often a difficult choice for a parent even though (i) the parent knows this to be true; and (ii) the parent probably knows which child should lead. The failure to recognize this difficult reality can be highlighted by the Nordstrom company which recently abandoned its management structure consisting of seven Co-CEOs made up of children and grandchildren of the founders.
3. If ownership is divided among multiple children, it is important to retain a mechanism that brings control back to one child. This can be accomplished through shareholder agreements.

It may be appropriate to examine spin-off or split-up opportunities with each child being given a separate business or line of business to operate.

F. No One Wants Business

1. If no one wants the business, the business can either be sold or liquidated.
2. If the business is to be sold, possible purchasers include:
 - a. A competitor or strategic purchaser in a taxable acquisition or tax-free merger;
 - b. Key management; or
 - c. An ESOP.

VI. CASHFLOW

A. Introduction

1. It is important to assure the business owner of sufficient cashflow during the planning process. Business owners who perceive a threat to their personal financial security will be more reluc-

tant to give up control. Therefore, it is important to assure the business owner of adequate cashflow, before addressing control issues.

2. Under the theory that “a dollar is a dollar is a dollar,” the planner should next demonstrate to the business owner that equivalent amounts of income, from whatever source, put the business owner in the same economic position. The planner should teach the business owner to focus on after tax cash flow and not the source of income.
3. This can be accomplished by shifting the business owner’s sources of income from sources over which the business owner may have control—i.e., salary, bonus, S corporation distributions, C corporation dividends, or partnership distributions to sources of income that are contractually assured—i.e., rental payments, salary continuation payments, consulting fees, qualified and non-qualified deferred compensation, non-compete fees, and buy-out payments through an installment sale, self-canceling installment note (“SCIN”), or a private annuity.

B. Salary Continuation Plans

1. One means of providing for the owner’s financial security, while also suggesting the need to transition to a retirement status, is through a salary continuation plan. These involve an agreement by the business to have some of the owner’s compensation paid in a later year than the year earned. The agreement is an enforceable contract (thus providing security to the owner if control is shifted), but generally is evidenced by an unsecured promise to pay at retirement. Most plans are not subject to the nondiscrimination and reporting requirements of qualified plans under ERISA, although they are required to be “unfunded”; as a result, the owner is somewhat at risk if the succeeding generation is not successful with the business, so this should be only a part of the retirement plan of the owner.
2. In smaller family business situations, these plans may be as simple as providing for the owner’s salary to continue for a specific period of time after retirement, or even until the death of the owner and his or her spouse.
3. If more security is desired, however, it may be possible to utilize a rabbi or secular trust. The rabbi trust is an irrevocable grantor trust established by the business to “fund” the deferred obligations of the salary continuation plan, and the assets can be used only to pay that compensation or the claims of creditors. The income of the trust is taxed to the business until amounts are actually paid to the employee. This is not the case with a secular trust, but its assets are not subject to the claims of the business creditors; the trade off, of course, is that the employee is taxed at the time the assets are contributed to the trust.
4. Sometimes these payments will be funded through “keyman” insurance, in which the cash value buildup is used to provide the cash flow to fund the salary payments.

5. Of course, the plan should indicate quite clearly to whom the benefits are to be paid and whether there will be an alternative beneficiary after the death of the owner and spouse, unless payment is tied to their lives (as it generally should be to avoid the adverse impact of the next generation receiving income in respect of a decedent).

See, Koren, Non-Tax Considerations in Family Business Succession Planning – Part Two, Koren Estate and Personal Financial Planning Update, September 2002.

C. Installment Sale

1. A simple alternative to an outright gift or a private annuity transaction is a sale of the business owner's entire interest in the business in exchange for an installment note.
2. If the business owner's basis in the transferred interest is significantly lower than its fair market value, recognition of capital gain can be deferred over the entire period of the installment note under Code § 453.
3. A major advantage of the installment sale technique is the ability to set a relatively low interest rate on the promissory note payments and avoid the possibility that the transaction will be re-characterized as a bargain sale. In *Frazee*, 98 T.C. 554 (1992), the Tax Court held that the Code § 7872 rates will apply to determine whether or not an installment note will be valued at less than face value for the purposes of the application of the gift tax.
4. If the installment sale technique is utilized, care must be taken to coordinate the balance of the transferor's estate plan with the installment note technique. For example, upon the transferor's death, the fair market value of the note will be included in his or her estate. Assuming that the note is left to the obligor under the note, the tax apportionment provisions of the estate plan might provide that the obligor bear the transfer tax liability attributable to the note.
5. If the property transferred has a fair market value significantly in excess of its basis, the untaxed portion of the gain will be taxed to the transferor's estate (and reportable on the fiduciary income tax returns filed for the estate or trust) if the installment note is forgiven upon the transferor's death, or transferred to the obligor as a consequence of transferor's death. *Frane v. Commissioner*, 98 T.C. 341 (1992), *reversed in part and affirmed in part*, 998 F.2d 567 (8th Cir. 1993). The capital gain so recognized will constitute an item of income in respect of a decedent under Code §§ 453B(f)(1) and 691(a)(2).
6. The transferor may desire to elect out of the installment method at the time the sale is consummated, and recognize all capital gain liability in the year of sale. This will eliminate the future taxation of the unrecognized gain as income in respect of a decedent. Effectively, if the transferor is in the 40% estate tax bracket, the government will be paying 40% of the income tax liability attributable to the gain recognized in the year of sale.

7. If the transferor desires, he may utilize the \$14,000 gift tax annual exclusion to forgive a portion of the installment note payments each year (up to \$28,000 per year if the transferor is married and the gift splitting election under Code § 2513 is made for all gifts made during the applicable calendar year). However, if the forgiveness of the note payments is part of a prearranged plan, the Service could argue that the transaction constitutes a bargain sale. See, e.g., Rev. Rul. 77-299, 1977-2 C.B. 343. The forgiveness of payments will cause recognition for income tax purposes of the gain element inherent in the forgiven payment.
8. Assuming that the purchaser of the business interest materially participates in the business, and that the business is carried on as a partnership or S corporation, it is likely that the purchaser will be able to deduct the interest paid on the promissory note, and will not be subject to the investment interest limitations of Code § 163(d). See Code § 163(d)(5)(A); PLR 9037027.

9. Advantages

- a. All future appreciation in the value of the property sold is removed from the transferor's estate.
- b. Assuming that the purchaser remains solvent, the transferor is guaranteed a fixed revenue stream for the term of the installment note.
- c. The purchaser of the stock immediately receives a basis in the stock equal to the purchase price, even though the payment of the purchase price will be deferred over the period of the note. If the sale is structured as a sale to a "defective" grantor trust, however, the trust will assume the seller's basis in the stock.
- d. In the current low interest rate environment, the interest rate payable under the note need not exceed the applicable rate under Code § 7872. This results in minimizing the growth of the transferor's estate from his or her receipt of interest payments. In addition, when the transferor dies, the appraised value of the installment note should reflect a significant discount for the low interest rate payable under the note, provided that the note is left to someone other than the obligor.

10. Disadvantages

- a. The transferor's estate will forgo a basis step-up in the installment note for the unrecognized deferred gain.
- b. The purchaser must continue to make the installment payments, even if the value of the purchased asset declines in the period following the sale.

- c. If the transferor is dependent upon the installment note payments, and the purchaser subsequently is unable to make the payments, or receives a discharge in bankruptcy, the transferor may not have any recourse other than a security interest in the assets sold which may have become worthless.

D. Self-Canceling Installment Note

1. A self-canceling installment note (“SCIN”) is defined as a debt obligation that by its terms is extinguished at the death of the seller-creditor, with the remaining note balance cancelled automatically. The primary advantage of a SCIN over a straight installment sale is that if the seller dies prior to the expiration of the installment term, the remaining value of the installments are totally excluded from the seller’s estate. Moreover, the SCIN provides an advantage over a private annuity in that the seller does not incur the tax risk of living well beyond the installment term, thereby increasing the seller’s gross estate by continued annuity payments.
2. To compensate the seller for the risk of cancellation, the SCIN must contain a “risk premium,” which may be reflected either in the purchase price of the assets or the interest rate of the note. Consequently, for the SCIN to be beneficial from an estate planning standpoint, either of the following must occur:
 - a. The return on the asset that is sold must exceed the interest rate on the SCIN.
 - b. The seller must die before his or her life expectancy.
3. SCIN may be classified as either an installment sale or a private annuity for income tax treatment and valuation purposes. If the maximum term of the SCIN exceeds the life expectancy of the seller (as determined under Reg. 1.72-9), the SCIN is classified as a private annuity. If the installment term does not exceed the seller’s life expectancy, the SCIN is classified as an installment sale. The differences between these two methods are discussed below. In most situations, the preference is to structure the SCIN so that it is treated as an installment sale.
4. IRS Rulings (GCM 39503) and case law have attempted to clarify some of the issues with respect to the income tax treatment and valuation of SCINs. Many of the uncertainties have been addressed in the last few years, creating the need to review the usefulness of SCINs in light of recent developments and current interest rates.

E. Private Annuities

1. A private annuity is a transfer of property from an annuitant (the transferor) who is not in the business of issuing annuities, to an obligor (the transferee) in exchange for the obligor’s promise to make periodic payments of fixed amounts for the remainder of the annuitant’s life

or other specified period. Private annuities also can be structured to have a joint and survivor provision.

2. The annuitant purchases the annuity by transferring money or other property to the obligor. The obligor may be an individual, corporation, trust, foundation, or other entity.
3. The most advantageous and common use of private annuities is for intrafamily transfers with the annuitant being the parent and the child being the obligor. Other common private annuity situations involve the redemption of stock by a closely held corporation in exchange for the annuity. Private annuities may, however, also be established between unrelated parties.
4. The tax consequences of private annuities are described in Rev. Rul. 69-74. The gain realized on a private annuity is the excess of the present value of the annuity over the annuitant's basis. The annuitant's income tax treatment is governed by Code § 72. Part of each annuity payment is a tax-free return of capital, while the remainder is subject to taxation.
5. Advantages. For annuitants who die prematurely, private annuities are a low transfer tax way to avoid having property taxed in the estate under Code § 2036. Aside from this (and for those who expect to live out their life expectancies), the greatest benefit of a private annuity is to a transferor (the annuitant) who wants to keep ownership of certain property within the family, while having the security of a fixed income for life. Further, the annuitant can remove any future appreciation on the transferred property from his or her gross estate. Property transferred within three years of the annuitant's death should not be included in the annuitant's gross estate, provided a life estate or security interest was not retained that would cause inclusion under Code §§ 2036, 2037, 2038 or 2042.
6. Disadvantages. The most precarious aspect of entering into a private annuity agreement is the annuitant's life expectancy. The uncertainty of death may cause difficulties. If the annuitant dies prior to his or her actuarial life expectancy, the obligor's basis may be lower than it would have been had the property been inherited. In the alternative, if the annuitant outlives his or her actuarial life expectancy, the annuity payments may exceed the value of the contract or the estate tax value assigned to the assets had it been retained by the estate. An annuitant who outlives his or her actuarial life expectancy will have to pay income tax on the entire realized gain. Further, if the annuitant does not spend the payments, they will increase his or her estate, perhaps by more than the underlying property would be worth if the annuitant outlives his or her life expectancy. An additional risk to the annuitant is that the obligor may predecease him or her—jeopardizing the receipt of future payments. Because annuity payments are usually made from after-tax dollars, with part of the payments being included in the annuitant's income as interest, a private annuity may increase the overall tax burden to the parties involved. Even though the annuitant receives interest income, the obligor cannot take the interest expense deduction for any portion of the annuity payment. If the property used to fund the an-

nuity is of a very high economic value, it may place a financial burden on the obligor to make such high annuity payments.

VII. CONTROL

A. Introduction

1. The decision regarding who gets control is critical. Ideally, control should be in the hands of as few persons as possible. A business needs one person to serve as the leader and the focal point. It is difficult for many parents to choose one child over another when decisions relating to control need to be made.
2. Ideally, decisions relating to control should be based on merit, competence, and sustained performance, as opposed to relationship.
3. Control and ownership are distinct rights and can be separated using a variety of legal mechanisms, including voting and non-voting equity ownership interests.
4. The timing for the transfer of control is critical. If control is transferred too early, the business owner may have a tendency to meddle or second-guess the successor. In addition, a prematurely designated successor may be ill-prepared to assume the role. Similarly, a business owner's retention of control until death or disability can produce disastrous results including either (i) a power struggle or (ii) a leadership vacuum.
5. Ideally, a successor should be identified, but not necessarily announced. The candidate can be groomed, given increasing opportunities and responsibility - to the extent the candidate rises to the task. To the extent the candidate continues to develop, the business owner can involve the candidate in large decisions affecting the company. Finally, once the business owner is ready to retire and the successor is adequately prepared, full control can be transferred to the successor.
6. It is important to consider the collateral effect on key employees when there is a transfer of control. In some cases, the key employee may be a contemporary and close friend of the retiring business owner. The key employee may perceive the transfer of control to the next generation as a threat. Therefore, it may be appropriate to enter into an employment agreement, deferred compensation or other arrangement with the key employee to provide adequate security.

B. Buy-Sell Agreements

1. Introduction

- a. Ownership and management in a closely-held corporation are more intermingled than in publicly-held business entities. Many closely-held corporations consist entirely of a single family or person. In such cases, the issue of outsider participation in the business becomes increasingly important when a shareholder dies or must dispose of his or her interest.
- b. Shareholder, or buy-sell agreements as they are also called, can be used to provide that either the corporation or its shareholders may or must purchase the interest of a shareholder on the death or disability (or other disqualifying event) of that shareholder.
- c. For the decedent's estate, buy-sell agreements can facilitate the liquidity of the decedent's assets by providing a means for the estate to receive cash or other liquid assets rather than a likely unmarketable interest in a closely-held corporation.
- d. A shareholder agreement can also remedy the problem of valuing an owner's interest in the business. A properly drafted shareholder agreement can establish the estate tax valuation of a decedent's interest.
- e. A shareholder agreement may provide a method for extracting funds from the family business in a form other than a dividend.
- f. A shareholder agreement can help to eliminate conflict among the remaining shareholders and the deceased shareholder's family and/or estate by providing an orderly mechanism for the disposition of the business interest, as opposed to potentially meddlesome involvement by a surviving spouse who is more interested in smaller salaries and larger dividends.
- g. A shareholder agreement can help to ensure that an S corporation retains its status by preventing its shares from falling into the hands of ineligible S corporation shareholders.

2. Cross Purchase Agreement

- a. The cross purchase agreement is an agreement whereby an outgoing shareholder or his or her estate must sell to the remaining shareholders all of his or her stock, with the remaining shareholders in turn either being obligated or having the option to buy the stock. The corporation itself is not involved in the purchase and sale of the stock. It is often recommended that the shareholders purchase insurance policies on the life of each shareholder in order to fund the purchase of the shares of the outgoing shareholder in the event of his or her death. The number of insurance policies required is equal to $N(N-1)$, where N equals the number of shareholders of the corporation.
- b. Advantages

- i. The tax basis of the surviving shareholders' stock is increased by the amount they pay for the decedent's stock.
 - ii. There is no attribution of ownership and thus no dividend problem in the case of a family corporation. (See Code §§ 302 and 318.)
 - iii. Because the surviving shareholders generally purchase the decedent shareholder's stock on a proportional basis, the relative interest of each shareholder in the corporation remains unchanged.
 - iv. The creditors of the corporation do not have an interest in the life insurance policies used to fund the purchase.
 - v. The corporation does not incur any problems related to any accumulated earnings because the corporation does not fund the purchase.
 - vi. Although insurance premiums are not deductible by the shareholders, the proceeds are not subject to tax (although if the corporation pays the premiums on behalf of the shareholders, such amounts are taxable as dividends).
- c. Disadvantages
- i. If life insurance is used to fund the purchase, administering the cross purchase agreement with multiple insurance policies is difficult if there are many shareholders.
 - ii. Shareholders with limited financial resources may not be able to purchase the decedent's stock if insurance is not the basis of funding the purchase.
 - iii. The plan may be disrupted if a shareholder becomes insolvent.
 - iv. If life insurance is used to fund the purchase, premiums on the lives of older shareholders will be higher than those for younger shareholders. If younger shareholders must pay for the higher premiums, this could cause dissension between the older and younger shareholders.
 - v. Insurance policies held by each shareholder are subject to the claims of such shareholder's creditors.
 - vi. If the obligation to purchase the stock is mandatory upon the shareholders and then assumed by the corporation, it may result in a constructive dividend to the shareholders.

3. Redemption Agreement

- a. A second type of buy-sell agreement is a corporate redemption whereby the corporation and its shareholders agree that if a buy-sell obligation arises, such as upon the death or disability of a shareholder, the corporation will buy all the outstanding shares of that person and the shareholder or representative of his or her estate agrees to sell all shares at a price determined pursuant to the buy-sell agreement.
- b. Since the corporation itself funds the purchase, careful consideration should be given to funding the purchase through insurance purchased on the lives of the shareholders. Shareholders should also consider including provisions in the buy-sell agreement requiring the corporation to purchase life insurance and limiting the corporation's ability to borrow against the insurance policy or policies.
- c. The corporate tax implications regarding a redemption cannot be ignored. A redemption is a distribution to which Code §§ 302 and 303 apply. If encumbered property is used by the corporation as consideration for the redemption, and if the liability exceeds the corporation's basis in that property, then the corporation recognizes the excess amount as gain. Code §§ 302, 303.
- d. The shareholder's estate receives capital gains treatment when the stock is sold if all of the shareholder's stock is redeemed. Code § 302(b)(3). If all of the stock is not redeemed, capital gains treatment applies to the estate if the amount redeemed is not more than is required to pay all death taxes and allowable costs of the administration of the estate. Code § 303.
- e. Care should be taken with the business owner's estate plan to ensure capital gain treatment under a "complete termination of interest" or Code § 303 scenario. If stock passes to a family or marital trust, exchange treatment may not be available, as the waiver of family attribution only applies to individuals and not entities. The solution to this problem, if a redemption is anticipated, is for the business owner to leave the stock to the surviving spouse, outright, who can then (i) waive family attribution; and (ii) qualify for exchange treatment.
- f. Advantages
 - i. The interests of the remaining shareholders increase proportionately to the stock redeemed, and the increase is not taxable.
 - ii. If insurance is used to fund the stock redemption, the policies and policy proceeds become a corporate asset.

- iii. Only one corporate insurance policy per shareholder is needed, as opposed to several in a cross-purchase buy-sell agreement.
 - iv. The shareholder's estate receives capital gains treatment from the redemption.
 - v. Creditors of the individual shareholders do not have recourse to the insurance policies.
- g. Disadvantages
- i. A redemption by a Virginia corporation may be illegal if the corporation does not pass either the balance sheet or equity insolvency test. (See Va. Code Ann. § 13.1-653.)
 - ii. A redemption by the corporation does not give the remaining shareholders a step-up in basis.
 - iii. A redemption by a closely held family corporation may be treated as a dividend through application of the appropriate attribution rules. (See Code § 318(a)(1)).
 - iv. If insurance is purchased by the corporation, premiums are not deductible.
 - v. A corporation, without insurance, may experience a reduction in earnings and profits and be unable to fund the redemption.
 - vi. Policies owned by the corporation may not be transferred to shareholders without transfer for value problems.
 - vii. The redemption by the corporation may create unintended shifts in control.

4. Hybrid or "Wait and See" Agreement

- a. The "wait and see" shareholder agreement format combines features of both the cross purchase and the entity redemption agreements in order to give the shareholders and the corporation the opportunity to determine which approach is most advantageous.
- b. The usual agreement would give the shareholders an option to purchase the stock on the death, disability, or termination of employment of the shareholder. If the shareholders do not exercise this option to purchase all of the shares, the corporation would then either have the ongoing option or would be bound to purchase the remainder of the stock.
- c. The insurance policies are usually owned at the shareholder level and are used first by them to acquire stock. The unfunded balance is then acquired by the corporation.

- d. If this approach is followed, it is critical that the shareholders only be granted an option to purchase the shares. Otherwise, if the corporation purchases some of the shares, the IRS may take the position that the shareholders have received a constructive dividend.

5. Events Triggering Purchase Obligation

- a. **Death.** If death is a triggering event, it is helpful to include language authorizing the Corporation or the other shareholders to deal with the decedent's executor and personal representative and vice-versa.
- b. **Disability.** If disability insurance is procured to fund this obligation, it is helpful to coordinate the definition of disability with the policy definition of disability.
- c. **Termination of Employment; Loss of Licensure** It may be appropriate to make a distinction between a voluntary and involuntary termination. This provision is critical for key employees.
- d. **Bankruptcy.** This will help to avoid the Bankruptcy Trustee's participation in the company. If the purchase price is below fair market value, the provision may be unenforceable under the Bankruptcy Code.
- e. **Divorce.** This option should be considered in the event shares are transferred to a spouse of the business owner's children in order to facilitate a gifting program.
- f. **Right of First Refusal.** This option should be included in almost all instances to ensure that shares remain "within the family" before being sold to an outside, third party, including a competitor.
- g. **Puts, Calls, Tag-Along, Drag-Along.** A "put" may be useful to give a shareholder (typically a key employee) the option to monetize an equity ownership interest. Similarly, a "call" may give the corporation the ability to control the identity of shareholders. "Drag along" and "Tag along" rights are used in the context of the sale of 100% of the business enterprise and help to ensure that (i) a minority shareholder cannot block a sale; and (ii) a majority shareholder cannot sell its interest at a price or on terms that are more favorable to it than to the other minority shareholders.

6. Funding

- a. Insurance – Life and Disability;
- b. Corporate Earnings; or

- c. Debt Instruments.

7. Valuation

- a. Objective Standard. It is important to have method of determining value that is certain, determinable, reasonable, and comparable. Some valuation formulae or methodologies are better suited to some businesses than others.
- b. Agreed Upon Price. This approach is by far the easiest. However, it may over-value or under-value the business. In addition, in the case of a shareholder dispute there may be no method to adjust the price. Furthermore, many shareholders simply forget to update. Therefore, it is appropriate to include a mechanism to automatically adjust value if not adjusted by the affirmative agreement of the parties.
- c. Earnings Based Valuation Formulae. This type of formula provides for a capitalization of earnings as determined over a certain period of time, with or without adjustment for certain items (such as shareholder salaries) and may be weighted over a specific number of years. It is critical to select an appropriate capitalization rate that is reflective of the value of the specific type of business and industry.
- d. Book Value and Net Asset Value. Many clients favor a book value approach, because it is fairly readily available and easily determinable. Unfortunately, it may or may not reflect the true value of business, as it reflects the historic cost of assets, less depreciation. It may be appropriate to adjust book value for such items as:
 - i. Assets not appearing on the balance sheet, such as goodwill and work in progress;
 - ii. Any accrued income or expenses not appearing on the balance sheet;
 - iii. Any contingent liabilities;
 - iv. Appraised value of certain assets, such as real estate or large machinery;
 - v. Market value of publicly traded securities;
 - vi. Loss of deceased owner's services; and
 - vii. Insurance proceeds.
- e. Appraisal Method. This method contemplates that the business interest be valued upon the occurrence of an event giving rise to the obligation or option to purchase or sell an interest under the terms of the agreement.

f. Valuation Discounts

- i. A minority interest in a closely held entity may be subject to minority interest and lack of marketability discounts.
- ii. The agreement should, at a minimum, set forth the standard of value – fair market value or investment value (not recommended in an estate planning context), and should specify whether valuation discounts or premiums should be taken into consideration.
- iii. There is an inherent tension when family members and non-family members own stock in the same entity. The senior family members may wish to transfer their business interests to their family at a large discount. Similarly, key employees will seek to maximize the value of their business interests.
- iv. Consequently, it may be appropriate to use (i) separate shareholder agreements among family members and key employees, and (ii) provide for additional forms of compensation to key employees, such as non-compete or consulting payments to compensate the key employee for the loss of value attributable to a valuation discount.

8. Payment Method

- a. If insurance is available to fund obligation and event has been triggered, cash proceeds of insurance are used to purchase interests, to the extent of the proceeds.
- b. If insurance is not available or the purchase price exceeds the proceeds received, the balance may be paid with a promissory note.
- c. The note will typically bear interest at (i) the applicable federal rate under Code § 1274(d), (ii) a fixed rate, or (iii) a floating rate based on an externally determinable rate, such as *Wall Street Journal* prime rate plus 2%.
- d. The note will typically be secured by the interest being purchased.

9. Code § 2703. Attorneys drafting shareholder agreements should be cognizant of the requirements of Code § 2703 which governs buy-sell agreements which are entered into or substantially modified after October 8, 1990. Code § 2703(a) provides that, in general, any option, agreement, or other right to acquire property at a price less than the fair market value of the property will be ignored in determining the value of such property for estate, gift, and generation-skipping tax purposes. However, Code § 2703(b) provides an exception to the general rule

of Code § 2703(a). It provides that Code § 2703(a) shall not apply to an option, agreement, or other arrangement that meets each of the following requirements:

- a. It is a bona fide business arrangement.
- b. It is not a device to transfer the property to members of the decedent's family for less than full and adequate consideration.
- c. Its terms are comparable to similar arrangements entered into by persons in an arms' length transaction.

Each requirement for the exception must be met independently. The mere showing that an agreement is a bona fide business arrangement is not sufficient to establish that it is not a device to transfer property for less than full and adequate consideration. However, an agreement is considered to meet all of these requirements if 50% of the value of the property that is subject to the agreement is owned by persons who are not members of the transferor's family and who are subject to the same restrictions as family members. Treas. Reg. §§ 25.2703-1(b)(2), (3).

C. Stock Recapitalization.

1. Prior to the enactment of Chapter 14, a popular estate planning technique involved the retention by the older generation of a preferred class of stock having a fixed value and the gifting to the younger generation of a class of common stock which carried all the future appreciation.
2. A simpler form of re-capitalization still exists which allows a business owner to transfer equity interests in the business while retaining substantial control.
3. Example: Corporation X owned by Father has one class of voting common stock with 1,000 shares authorized and 100 shares outstanding. The corporation has a fair market value of \$1,000,000. If Father wished to start a gift program, a gift of one share of the company's common stock would represent 1% of the equity of the company, or \$10,000, before any applicable valuation discounts are taken. In order to facilitate Father's annual gift program, the Company is "recapitalized" pursuant to the following steps:
 - a. The articles of incorporation are amended to authorize 1,000 shares of Class A Voting Common Stock and 10,000 shares of Class B Non-Voting Common Stock.
 - b. A "plan of recapitalization" is adopted under which the existing class of common stock (including the 100 shares outstanding) is automatically converted into Class A Voting Common Stock.

- c. The board of directors declares a stock dividend of 9 shares of Class B Non-Voting Stock for each 1 share of Class A Voting Common Stock outstanding.
 - d. Result: Father now owns 100 shares of Class A Voting Common Stock and 900 shares of Class B Non-Voting Common Stock. Assuming for purposes of this illustration that the economic rights for each of the 1,000 outstanding shares is equal (although each share of Class A Voting Stock likely has at least some additional value), each share represents underlying equity of \$1,000 before any applicable valuation discounts are taken.
 - e. Assuming an overall 40% valuation discount is appropriate, Father could give 16 shares of Class B Non-Voting Stock to his daughter each year, without diluting his control over the company ($16 \times \$1,000 \times (100\% - 40\%) = \$9,600$).
4. Thus, this form of “recapitalization” accomplishes the following:
 - a. It results in a “thinning” of the equity of the company so that periodic gifting is more easily accomplished.
 - b. It permits the older generation to retain control of the company by giving away non-voting stock while retaining the voting stock.
 5. While Father’s voting stock would likely be valued at his death with a “control premium,” Father could periodically give away voting shares as well so that he holds only a minority position (if any) in the company at his death.
 6. Under Treas. Reg. § 1361-1(l)(1), an S corporation is treated as having only one class of stock if all outstanding shares of stock confer identical rights to distribution and liquidation proceeds. Differences in voting rights are disregarded.

VIII. EQUITY

A. Introduction

1. Ideally, children or other family members who are actively employed in the business should receive equity ownership interests in the business. Similarly, children or other family members who are not actively employed in the business should receive other assets that comprise the business owner’s estate.
2. Multiple owners in a business can hamper the decision making process, since a consensus must usually be reached. In addition, active owners are subject to criticism by non-active owners that (a) salaries for the active owners are too high and (b) dividends and distributions are too low.

3. Unfortunately, for many business owners, the business represents the single largest asset in the business owner's estate and it may be impossible to divide the business owner's assets equally among his or her children without including some portion of the business.
4. If non-active children must receive an interest in the business to achieve the level of equality desired by the parent, it is preferable to use non-voting equity interests.

B. Separate Operational Business Assets from Passive Business Assets

1. One strategy to alleviate this conundrum is to separate operational business assets from passive business assets.
2. For example, a business is operated as an S corporation. The business owner also owns, through a separate LLC, the real estate leased to and occupied by the business.
3. The business owner should consider transferring the S corporation stock to the children who are actively involved in the business and the LLC interest to the children who are not actively involved in the business.
4. It is critical that the S corporation and the LLC have a binding, long-term lease agreement with fair market rent. In addition, the child who is active in the business may be required to buy out the interests of his or her sibling who are not active in the business.
5. These requirements should be dictated by the parent and not left for the children to decide (or not decide) among themselves.

C. Key Employees

1. In many instances, a key employee may seek equity ownership in the business. For a number of reasons, it may be preferable to deny equity ownership to a key employee:
 - a. It may be difficult to meet or satisfy a key employee's expectations with respect to their role as both a shareholder and an employee. In the end, they too, will be a minority shareholder in a closely held business and will have little say or control over the direction of the company.
 - b. Outside ownership may make it difficult for the family to achieve valuation planning goals because of the key employee who seeks to maximize value which countervails the family's goal to depress value.

2. It is preferable to design and implement structures that simulate equity ownership. These structures can include vesting and forfeiture provisions. Among the techniques that can be considered are the following:
 - a. Phantom-stock plans.
 - b. Non-qualified deferred compensation arrangements.
 - c. Supplemental retirement plans
 - d. Structured bonuses or bonuses contingent on future sales.
 - e. Split dollar arrangements.
3. If a key employee receives an equity ownership interest, it is preferable to use a separate buy-sell agreement than that used with family members. A redemption format is usually preferable in this context. In addition, additional forms of compensation for the key employee upon a buy-out, such as an accompanying non-competition or consulting agreement, can help to minimize buy-out valuation issues.

IX. EMPLOYMENT

A. Opportunity v. Obligation v. Birthright

1. For some children, the opportunity to work in the family business is a great blessing. For other children, it may be viewed as a forced career path, creating resentment in the child and problems in the business.
2. Similarly, some children, they may view the ability to work in the family business as a birthright. The child may expect ample compensation from the business, whether or not earned. This can create a different, but equally divisive set of problems.
3. The decision to work in the family business should be viewed as an opportunity, if earned, and not an obligation or a birthright.

B. Merit Based Hiring

1. The opportunity to work in the business should be based largely on merit.
2. The family should identify measurable standards and criteria for hiring, termination, retention, and promotion.

3. This should include education, experience, salary ranges commensurate with job function and responsibility, and job performance standards.

X. RETENTION v. SALE

A. **The Decision to Sell or Retain the Business.** Many business owners will contemplate the sale of the family business. They will rarely share these thoughts with their business advisors or their families. Some business owners are shocked to learn (i) the value of their business may not be as high as they estimated; or (ii) how little they will actually reap after a sale is consummated.

B. Reasons for Sale

1. **Maximize Value Through Sale to a Competitor or Roll-Up.** The business may be sold to a third party competitor at a premium.
2. **No Clear Successor.** The younger generation and/or the key employees are not adequately prepared, capable, or interested in carrying on the business.
3. **Risky Business with Little or No Future.** The long-term risks of continued ownership or succession may justify a sale.

C. Obstacles to a Sale

1. expectation of value.
2. Lack of qualified buyers.
3. Need for pre-sale planning.
4. Excessive reliance on business owner's capabilities, traits, goodwill, etc.
5. Business owner's hesitancy to part with symbol of significance and prestige.
6. Taxes incurred on sale.
7. Third party approvals—lenders, governmental, franchisors, and licensors.

D. **Potential Purchasers.** If the business is to be sold, possible purchasers include a competitor or strategic purchaser in a taxable acquisition or tax-free merger, a sale to key management; or a sale to an ESOP.

E. Employee Stock Ownership Plans

1. An ESOP is a qualified retirement plan designed to invest primarily in employer securities. Code § 4975. The ESOP is separate from the company; therefore a sale to an ESOP does not violate the corporate redemption rules of Code § 302.
2. Under Code § 1042, if the business owner sells his stock to an ESOP, the capital gain attributable to the sale of such stock may be deferred, if the proceeds of sale are reinvested within 3 months before or 12 months after the sale in securities issued by domestic corporations that are not holding companies. The seller receives a carry-over basis in the newly purchased replacement securities. In order to reap these remarkable tax benefits, several important rules apply:
 - a. The ESOP must own at least 30% of the total value of the stock after the transaction. Code § 1042(b)(2).
 - b. The purchased shares cannot be allocated to any employee who owns more than 25% of the stock or who is related (with the meaning of Code § 267(c)(4)) to the seller. Code § 1042(b)(3).
 - c. The seller must have held the stock for more than 3 years prior to the sale. Code § 1042(b)(4).
3. Under Code § 404(k), the company is permitted to deduct the amount of cash dividends paid on shares of stock held by the ESOP if the dividends are passed through to the plan participants by the plan. In addition, the company may be able to deduct dividends paid to the ESOP for interest and principal on a loan used to acquire ESOP shares.
4. In the S corporation context, all of the income and gain of the corporation flows through to the shareholders. An ESOP, like all qualified plans, is a tax-exempt entity. An ESOP is permitted S corporation shareholder. Therefore, if the ESOP owns all of the stock of the S corporation, no tax is paid on the income generated by the corporation. Code § 1042 treatment is unavailable with respect to the sale of S corporation stock to an ESOP.
5. While the stock of the corporation would be owned by the ESOP, it would be controlled by the ESOP's Trustees who are appointed by the Board of Directors of the corporation. This will effectively permit the business owner or his or her family to retain control over the company.
6. It should be noted that ESOPs are extremely complex entities – both from the formation and ongoing administrative perspectives. Therefore, the business owner should carefully weigh the benefits offered by the ESOP with the substantial ongoing administrative burdens it will create.

F. Sale of Goodwill

1. In many closely-held businesses, the business owner represents the key employee who is responsible for the growth and success of the business. A great deal of the goodwill associated with the business is attributable to the business owner.
2. *Martin Ice Cream, Inc. v. Commissioner*, 110 T.C. 189 (1998) presents an interesting planning opportunity. The *Martin Ice Cream* case involved Arnold Martin, an ice cream wholesaler who is generally credited with introducing premium ice cream, like Haagen-Dazs and Ben & Jerry's, into supermarkets. Martin and his corporation agreed to sell assets to Haagen-Dazs. The parties allocated approximately \$1.2 million of the purchase price to goodwill owned by Arnold Martin and approximately \$300,000 of the purchase price to the purchase and sale of corporate records owned by the corporation. In addition, Arnold Martin entered into a 3 year employment agreement with an annual salary of \$150,000 and a non-competition agreement of \$50,000 per year for 5 years.
3. The Tax Court upheld the allocation of a portion of the purchase price to the goodwill owned by Arnold Martin. The Tax Court focused on the fact that the employee-shareholder (i) did not have an employment agreement with the corporation and (ii) was not subject to a covenant not to compete prior to the sale of his goodwill. Based on these facts, the Tax Court concluded that the employee-shareholder's contacts and relationships in the ice cream distribution industry were never transferred to the corporation, were owned by the employee-shareholder, and were a separate saleable asset.
4. The benefit of allocating a portion of the purchase price to goodwill is that the purchaser of the goodwill will be able to treat the goodwill as Code § 197 intangible and depreciate it over 15 years.

XI. CONCLUSION

Almost every business succession plan is different. Surprisingly, the issues are almost always the same. Concerns about ownership, control, retention of a continuing income stream, reduced transfer tax costs, management succession, liquidity, and a desire for simplicity and certainty pervade. The goal of a good business succession planning lawyer is listen to the client's goals, objective, concerns, and fears, and develop a plan that achieves his or her goals and objectives without doing harm to the family dynamic or the family business.

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APPENDIX A**BUSINESS SUCCESSION PLANNING QUESTIONNAIRE
RELATING TO THE BUSINESS,
ITS OPERATIONS, MANAGEMENT, AND OWNERSHIP STRUCTURE**

From Michael D. Allen “Motivating the Business Owner to Act”,
American Law Institute – American Bar Association CLE Course of Study:
Estate Planning for the Family Business Owner, August 10, 2000.

1. Who are the key players?
2. Who are the current owners? Has ownership been promised to anyone else?
3. Do buy-sell agreements exist? How are they funded?
4. Who are the current officers and directors?
5. Which family members are currently active in the business? What positions do they hold? What are their competence and commitment levels? Are any in-laws active in the business?
6. Has a promise been made about who will succeed to control?
7. Are there family members who are not involved in the business that want in?
8. Who are the key employees? What key employee issues exist?
9. How deep is the management pool?
10. What is the business really worth? How has its estimated value been determined?
11. What assets are inside the business? What are the essential business assets?
12. What are its liabilities? How are they secured?
13. Is there exposure to additional liability?
14. How do rates of return compare to risks?
15. What are the income tax characteristics of the business?

16. What is the product mix? To what risks are products vulnerable?
17. What are the critical third party relationships? (creditors, suppliers, customers, etc.)
18. Who are the competitors? Does a new competitor loom on the horizon?
19. Is there a long-term business plan?
20. Why is the business profitable? What are its strengths? What are its weaknesses?
21. What are the current cash reserves?
22. What are the current sources of cash flow?
23. What are the income and expense attributes of the primary business assets?
24. What are the current uses of cash flow?
25. What are current salaries?
26. What additional demands on cash flow are expected?

APPENDIX B

BUSINESS SUCCESSION PLANNING QUESTIONNAIRE RELATING TO NON-BUSINESS ASSETS

From Michael D. Allen “Motivating the Business Owner to Act”,
American Law Institute – American Bar Association CLE Course of Study:
Estate Planning for the Family Business Owner, August 10, 2000.

1. What are the family assets held outside of the business?
2. What are the values of non-business assets?
3. What is the ratio of assets outside the business to assets inside the business?
4. What cash flow is currently generated by non-business assets?
5. What is the cash flow potential of non-business assets?

6. What is the appreciation potential of non-business assets?
7. Is there an investment plan for non-business assets?
8. Are there assets outside the business that are critical to the business?
9. Are there assets inside the business that could be migrated outside the business?
10. What liability exposure exists? Has the owner guaranteed business debt?
11. Have any assets been promised to particular family members?
12. Should an asset (such as a vacation home or farm) remain a “family asset?”
13. How much life insurance exists? Who owns it? Who’s paying for it? Who are the beneficiaries? Is it committed to buy-sell agreements? Are the owners insurable?
14. What is the status of retirement benefits?
15. How does the current estate plan allocate estate tax liabilities between business and non-business assets?

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