Business Succession Planning

June 10, 2019

11:20 a.m. – 12:20 p.m.

Connecticut Convention Center
Hartford, CT

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Lawyers' Principles of Professionalism

As a lawyer I must strive to make our system of justice work fairly and efficiently. In order to carry out that responsibility, not only will I comply with the letter and spirit of the disciplinary standards applicable to all lawyers, but I will also conduct myself in accordance with the following Principles of Professionalism when dealing with my client, opposing parties, their counsel, the courts and the general public.

Civility and courtesy are the hallmarks of professionalism and should not be equated with weakness;

I will endeavor to be courteous and civil, both in oral and in written communications;

I will not knowingly make statements of fact or of law that are untrue;

I will agree to reasonable requests for extensions of time or for waiver of procedural formalities when the legitimate interests of my client will not be adversely affected;

I will refrain from causing unreasonable delays;

I will endeavor to consult with opposing counsel before scheduling depositions and meetings and before rescheduling hearings, and I will cooperate with opposing counsel when scheduling changes are requested;

When scheduled hearings or depositions have to be canceled, I will notify opposing counsel, and if appropriate, the court (or other tribunal) as early as possible;

Before dates for hearings or trials are set, or if that is not feasible, immediately after such dates have been set, I will attempt to verify the availability of key participants and witnesses so that I can promptly notify the court (or other tribunal) and opposing counsel of any likely problem in that regard;

I will refrain from utilizing litigation or any other course of conduct to harass the opposing party;

I will refrain from engaging in excessive and abusive discovery, and I will comply with all reasonable discovery requests;

In depositions and other proceedings, and in negotiations, I will conduct myself with dignity, avoid making groundless objections and refrain from engaging I acts of rudeness or disrespect;

I will not serve motions and pleadings on the other party or counsel at such time or in such manner as will unfairly limit the other party's opportunity to respond;

In business transactions I will not quarrel over matters of form or style, but will concentrate on matters of substance and content;

I will be a vigorous and zealous advocate on behalf of my client, while recognizing, as an officer of the court, that excessive zeal may be detrimental to my client's interests as well as to the proper functioning of our system of justice;

While I must consider my client's decision concerning the objectives of the representation, I nevertheless will counsel my client that a willingness to initiate or engage in settlement discussions is consistent with zealous and effective representation;

Where consistent with my client's interests, I will communicate with opposing counsel in an effort to avoid litigation and to resolve litigation that has actually commenced;

I will withdraw voluntarily claims or defense when it becomes apparent that they do not have merit or are superfluous;

I will not file frivolous motions;

I will make every effort to agree with other counsel, as early as possible, on a voluntary exchange of information and on a plan for discovery;

I will attempt to resolve, by agreement, my objections to matters contained in my opponent's pleadings and discovery requests;

In civil matters, I will stipulate to facts as to which there is no genuine dispute;

I will endeavor to be punctual in attending court hearings, conferences, meetings and depositions;

I will at all times be candid with the court and its personnel;

I will remember that, in addition to commitment to my client's cause, my responsibilities as a lawyer include a devotion to the public good;

I will endeavor to keep myself current in the areas in which I practice and when necessary, will associate with, or refer my client to, counsel knowledgeable in another field of practice;

I will be mindful of the fact that, as a member of a self-regulating profession, it is incumbent on me to report violations by fellow lawyers as required by the Rules of Professional Conduct;

I will be mindful of the need to protect the image of the legal profession in the eyes of the public and will be so guided when considering methods and content of advertising;

I will be mindful that the law is a learned profession and that among its desirable goals are devotion to public service, improvement of administration of justice, and the contribution of uncompensated time and civic influence on behalf of those persons who cannot afford adequate legal assistance;

I will endeavor to ensure that all persons, regardless of race, age, gender, disability, national origin, religion, sexual orientation, color, or creed receive fair and equal treatment under the law, and will always conduct myself in such a way as to promote equality and justice for all.

It is understood that nothing in these Principles shall be deemed to supersede, supplement or in any way amend the Rules of Professional Conduct, alter existing standards of conduct against which lawyer conduct might be judged or become a basis for the imposition of civil liability of any kind.

--Adopted by the Connecticut Bar Association House of Delegates on June 6, 1994

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Morris W. Banks practices in the areas of corporate law, corporate securities, taxation, mergers and acquisitions and succession planning for closely held businesses. He has counseled numerous emerging and early stage companies and has been involved in more than $100 million of venture capital financings.

In addition to his substantial practice in the mergers and acquisitions arena, Moe has prepared and filed numerous requests for Private Letter Rulings and has received favorable rulings with respect to complex corporate reorganizations, divisive transactions and corporate re-capitalizations and restructurings in furtherance of closely held and family tax and succession planning engagements.

He has counseled clients in the motion picture industry with respect to the financial arrangements between producers and investors, qualifying for the Connecticut tax credit for certain costs associated with the production of digital media and motion pictures incurred in the State of Connecticut, employment agreements with performers and production staff, location agreements, and complex profit sharing arrangements with various participants in the development and production of media properties.

Moe has lectured on business planning at the University of Connecticut School of Law where he was an adjunct faculty member for over 30 years. He is an author of various articles related to taxation and business matters. Topics have included tax considerations in the purchase and sale of business interests, succession planning for the successful family business, forms of venture capital and structure of venture capital pools, and taxable and tax free mergers and acquisitions. A frequent lecturer before professional groups, Moe has participated as a panel member in symposia sponsored by the Connecticut Bar Association, the Federal Tax Institute of New England, the Connecticut Society of Certified Public Accountants, the Hartford County Bar Association, the University of Connecticut Income Tax School and various business groups such as the Connecticut Business and Industry Association.

Luke T. Tashjian is a partner at Whitman, Breed Abbott & Morgan in Greenwich, Connecticut where he practices corporate and business law, estate planning and administration, and tax law. His practice includes structuring tax efficient transactions; advising clients on the tax effects of proposed transactions; preparing estate planning and corporate documents; probating estates and preparing tax returns; representing businesses in mergers, acquisitions, and sales; forming for profit and not-for-profit entities; and representing parties in tax controversies and collection matters – including offers in compromise, claims for innocent spouse relief, U.S. Tax Court actions and U.S. District Court tax actions.

Luke graduated first in his class from the Boston University School of Law Graduate Tax Program in 2010 with an LL.M. in taxation after having received his J.D., with honors, from the University of Connecticut School of Law in 2006 and his B.A., *summa cum laude*, from the University of Connecticut in 2003. He was admitted to the Massachusetts bar in 2006, the Connecticut bar and the U.S. District Court for the District of Massachusetts in 2007, the U.S. Tax Court in 2008, the U.S. District Court for the District of Connecticut in 2011, and the New York bar in 2012.

Luke is chair of the Connecticut Bar Association's Tax Section and is a member of the Tax Section's Executive Committee. Luke is also co-chair of the Fairfield County Bar Association's Tax Committee.

Business Succession Planning (CLC2019-B02)

Agenda

11:20 a.m. – 11:50 a.m.	Presentation by Luke Tashjian
11:50 a.m. – 12:05 p.m.	Presentation by Morris Banks
12:05 p.m. – 12:20 p.m.	Case Study Review

Business Succession Planning

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Why Should A Client Engage In Business Succession Planning?

1. To reduce income and transfer tax costs.
2. To reduce the risk of the business failing (or being split up) if the owner becomes ill or dies.
3. To ensure that the transfer of the business is not delayed so long that options are no longer available.
4. To permit the owner to control how the business is disposed of.
5. To ensure that the business is transferred for its maximum value.
6. To protect the business from claims of a beneficiary's creditors.

Why is Succession Planning Often Delayed?

- It causes a business owner to confront very complex interpersonal factors including:
  - The Owner's Own Mortality
  - Family Dynamics.
  - Employee Dynamics.
  - Expectations of Co-Owners.
- Each group of individuals, family members, employees, and co-owners will have differing expectations regarding how the business should be transferred and what their role in the business should be.
  - The various expectations can create conflict and a fair plan does not necessarily treat everyone equally.

The Business Owner's Goals

- The first step in designing a succession plan is to identify the business owner's goals, including:
  - Required future income,
  - Level of continued business involvement,
  - The business owner's values, and
  - The legacy that the business owner desires to leave.

Goal of Converting Illiquid Asset to Liquid Asset

- In a succession plan a business owner is seeking to convert the owner's illiquid business interest into a liquid asset, usually cash, that the owner invests and uses to fund retirement expenses.
  - A team of advisors that includes financial advisors and the owner's accountant usually work together to determine the level of assets that the business owner requires and if the value of the business is sufficient to satisfy the owner's needs.
    - An appraiser will use one of three methods to value a business: (1) an asset approach under which the value of the business's assets (including good will) is used, (2) a market approach that examines recent sales of similar business, or (3) an income approach that examines the current value of the business's projected income.
      - Discounts such as for lack of marketability or lack or control are often applied.

The Form of the Business Entity

- The form of entity that the business is conducted in influences how a transactions is structured.
  - Most small businesses are conducted as LLCs.
    - An LLC with multiple members is by default classified for tax purposes as a partnership and an LLC with a single member is by default classified as a disregarded entity.
      - An LLC can file a form 8832, Entity Classification Election, to be taxed as either a C corporation or as an S corporation (in which case a Form 2553, Election by Small Business Corporation) must also be filed.
  - It is very common in succession planning to discover that the business was initially established as a C corporation.
    - If the entity was previously a C corporation then you must investigate if the built in gains tax that applies to asset sales within five years of conversion to an S corporation applies.

S Corporations

- A succession plan for an S corporation needs to take into account the S corporation requirements.
  - The shareholders of an S corporation are limited to:
    - Domestic corporations,
    - Individuals (other than nonresident aliens),
    - ESOPS, and
    - Qualified Trusts (Grantor Trusts, QSBTs, and ESBTs).
    - Partnerships, corporations, and nonresident aliens cannot be shareholders of an S corporation.
  - There cannot be more than 100 shareholders of an S corporation.
  - There can only be one class of stock.
    - Distinctions in voting rights are permitted.

Transferring a Business to Family Members

- If the business is transferred to family members then: (1) how are the owner's cash needs going to be funded and (2) how is the owner going to retain control over the transferred interests?
- Depending upon the owner's goals one of four methods is usually used to transfer a business to family members:
  - Gifting interests (this is usually to an irrevocable trust).
  - Selling the business to family members.
  - Selling the business to a grantor, beneficiary-grantor, or complex trust that the grantor establishes.
  - Transferring the business to a grantor retained annuity trust.

Gifting Business Interests to Trusts

- There is currently a gift tax annual exclusion of $15,000/donee or $30,000/donee if spouses elect gift splitting.
  - Only gifts of present interests qualify for the annual gift-tax exclusion.
    - A gift to a trust that does not contain a Crummy right may constitute a gift of a future interest.
    - A gift of a non-productive and non-income producing interest in a business entity may also constitute a gift of a future interest. *Hackl. V. Commissioner.*
- Note, that the GST annual exclusion also requires that the trust benefit only one skipped person and that the balance of the trust be included in the skipped person's estate on the skipped person's death.
- If the gift is of an interest in a hard to value asset then a defined value clause is usually included in the transfer documents. *See Wandry v. Commissioner*.

Sales of Business Interests to Trusts

- Business owners often sell their interests in a business to a trust for a note, thus converting an equity interest into a creditor interest and freezing the value of the transaction.
  - The trusts can be complex trusts, grantor trusts, or beneficiary-grantor trusts.
    - Most often the sales are to grantor trusts, which are treated as being owned by the transferor for income tax purposes, but are treated as separate entities for estate tax purposes. This results in income not being recognized on the sale (including the interest payments on the note) but a gift tax not being due on transfer.
      - Usually a substitution power is included in a trust to make it a grantor trust
    - If a sale to a complex trust is used then you need to be careful because a change of domicile from Connecticut to another state can terminate installment sale reporting for Connecticut income tax purposes unless a bond is purchased.

Corporate Redemptions

- A redemption occurs when a corporation re-acquires the corporation's own shares.
- A corporate redemption can be treated as either a dividend under section 301 of the Code to the retiring or deceased shareholder or it can be treated as a section 302 sale or exchange.
  - A sale or exchange is preferable for a C corporation because dividends are subject to two levels of taxation.
  - A sale or exchange is preferable for an S corporation because it allows gain to be offset by the shareholder's basis.

Section 302 Identifies a Sale v. an Exchange

- Section 302(b) identifies four circumstances in which a redemption is treated as a sale or exchange and not as a dividend.
- Section 302(b)(3) is the most often applied exception in business succession planning because:
  - (1) It establishes a mechanical, as opposed to a subjective test, and provides that a redemption is not a section 301 distribution if the redemption terminates the shareholder's entire interest in the corporation.
  - In applying all of the section 302(b) exceptions except 302(b)(3) you need to apply the section 318 family attribution rules.
    - The section 318 family attribution rules will not apply to a section 302(b)(3) redemption if three requirements are met: (1) after the redemption the shareholder's only interest in the corporation is that of a creditor - the redeeming shareholder cannot be an officer, director, or employee of the corporation; (2) the redeeming shareholder cannot acquire any shares in the corporation except through bequest or inheritance within ten years of the redemption; (3) the shareholder must agree to notify the IRS if the shareholder acquires an interest in the corporation within ten years of the redemption.

Corporate Cross Purchases

- A cross purchase occurs when one shareholder sells his or her shares to the other shareholders.
- A cross purchase is an ordinary section 1001 transaction and has no effect on the corporation unless the corporation provided the funds.
  - The purchasing shareholders have a basis equal to what they pay for the shares and the selling shareholder recognizes capital gain to the extent the purchase price exceeds the shareholder’s basis.
  - If the corporation provides the funds then there is either income or a dividend to the purchasing shareholders.
- Section 453 installment sale reporting can apply to both a cross purchase or a redemption when a note is used.

Use of Life Insurance to Fund a Cross-Purchase of Shares

- When life insurance is used it is generally preferable to structure the transaction as a cross purchase rather than as a redemption.
  - When an individual receives life insurance proceeds the proceeds are not taxable income because of section 101(a)(1) of the Code unless there was a transfer for consideration.
    - With an S corporation when the corporation receives the proceeds it results in each shareholder obtaining a basis step-up for the amount of the proceeds, but the deceased shareholder already received a date of death basis adjustment under section 1014 so his or her basis adjustment will only result in a capital loss, which can only be used to offset capital gains.
    - With a C corporation the shareholders do not receive a basis step-up if the corporation redeems the shares with the life insurance, but the corporate AMT has been repealed and is at least no longer an issue with life insurance being used for a C corporation redemption.
- The premium payments are not deductible regardless of if the corporation or the shareholders own the policy.

Employee Stock Option Plans (ESOPS)

- An ESOP may be used to sell a corporation (or a percentage of it) to employees while deferring the recognition of gain.
  - An ESOP is a qualified employee retirement plan that invests in a company's stock.
    - It is managed by a trustee selected by the corporation's board of directors.
    - If the company is an S corporation then since the ESOP is a tax-exempt entity the S corporation income that is attributable to the ESOP's shares escapes income taxation.
  - The ESOP borrows money to purchase shares in the company. The company then makes tax deductible contributions to the ESOP that are used to repay the loan.
  - If the company is a C corporation and the owner transfers at least 30% of its shares to the ESOP and the owner held the shares for at least three years before the sale then the owner can take advantage of section 1042 roll-over and not recognize gain until the owner sells stock that the owner acquired with the proceeds of the transaction.

Redemptions to Pay Shareholder's Final Expenses

- If the requirements of section 303 of the Code are met a redemption will be treated as a sale or exchange even if the requirements of section 302 are not met.
  - Since section 1014 provides for a date of death basis adjustment there will likely not be any gain recognized in the redemption.
- Section 303 has five requirements:
  - (1) The value of the stock in the redeeming corporation must equal at least 35% of the decedent's estate or 35% of the decedent's estate must be comprised of stock in two corporations and at least one corporation comprises 20% of the decedent's estate.
  - (2) The redemption must occur within ninety days after the expiration of the three year estate tax assessment period.
  - (3) The redemption amount cannot exceed the decedent's final expenses and estate taxes.
  - (4) If the corporation distributes appreciated property the corporation will still recognize gain.
  - (5) The redeeming party must be liable to pay the decedent's estate taxes and final expenses.

Cross Purchase of a Partnership Interest

- A cross purchase of a partnership interest by one partner from another is treated the same as if the retiring partner sold the interest to an outsider.
- First, the amount of gain that is recognized must be determined. This is the value of any consideration that the partner receives plus the partner's share of any partnership level debt.
- Second, the amount of the gain attributable to "hot assets" must be determined.
  - Section 741 provides that the gain or loss will be a capital gain or loss except to the extent that it is attributed to the retiring partner's share of section 751(a) hot assets.
    - Section 751(a) assets include: the seller's share of unrealized receivables, inventory items, and depreciation recapture.
    - The character of the gain is determined on an asset by asset basis.
- Third, the amount of the gain that must be recognized as ordinary income under section 751(a) is subtracted from the amount realized. The seller's outside basis is then subtracted from the remaining balance of the amount realized to arrive at the amount of capital gain or loss that the seller recognizes under section 741.
  - The selling partner's outside basis only reduces the partner's section 741 capital gain. It does not reduce the selling partner's section 751 ordinary income.

Retirement of a Partnership Interest

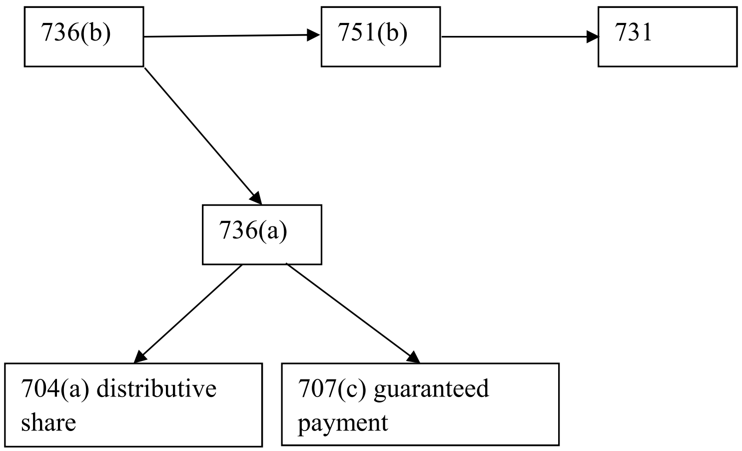
- Section 731 provides that partnership distributions usually only result in gain recognition to the extent that cash (including deemed debt relief) and marketable securities distributed exceed the recipient partner's outside basis.
- Section 736 is an exception to section 731 and provides that if a partner's entire interest in a partnership is retired then retirement payments must be bifurcated into two parts.
  - (1) Payments for a partner's interest in partnership property in which case the payments are governed by section 736(b).
    - The normal section 731 partnership distribution rules apply to section 736(b) distributions.
  - (2) payments governed by section 736(a) that are taxed as ordinary income to a retiring partner as either a guaranteed payment under section 736(a)(2) or as a distributive share of partnership income under section 736(a)(1).

Retirement of Partnership Interests in Capital Intensive Partnerships

- If the entity is a capital intensive partnership or the retiring partner is not a general partner (*i.e.* the partner is a member in a limited liability company who enjoys limited liability under state law) then all of the payments will be governed by section 736(b).
  - The retiring partner's gain will then constitute capital gain to the retiring partner, except for section 751(b) gain attributable to a distribution of unrealized receivables or substantially appreciated inventory items; which includes depreciation recapture and accounts receivable. 26 U.S.C. §§ 731, 741 & 751(b).
  - The portion of the retiring partner's amount realized that is attributable to unrealized receivables or inventory items is recognized by the selling partner as ordinary income. 26 U.S.C. 751(a).

Retirement Payments to Partners in Service Partnerships

- To determine the tax treatment of cash payments to a retiring general partner in a service partnership first calculate the gain to the retiring partner.
  - The gain is the amount realized minus the partnership's inside basis, plus the selling partner's share of relief from liabilities. The character of the gain must then be determined.
  - The character of the gain can then be analyzed with the following flow chart starting at the section 736(b) box.



- A payment goes to section 736(a) if it is either an unrealized receivable under section 751 (excluding recapture), substantially appreciated inventory, or if it is for the partnership's goodwill and the partnership agreement does not provide for the repurchase of goodwill.
- If the payment is contingent on future partnership income then the payment flows further down to section 704(a) and the payment is treated as a normal partnership distributive share of partnership income and the character of the income passes through to the redeeming partner and will constitute self-employment income to the retiring partner if the partner's distributive share would otherwise constitute self-employment income.
- If the payment that flows through section 736(a) is for a fixed amount then the payment goes to section 707(c) in which case the partnership can deduct it and it is automatically ordinary income to the redeeming partner and the payment is included in the partner's self-employment income. 26 U.S.C. § 736(a).
- In applying the flow chart amounts that do not flow down to section 736(a) must go through section 751(b).
- If the payment does not go down to section 736(a) then it will result in capital gain (and the partnership will not get a deduction for it) except to the extent that the asset is a section 751(b) hot asset. Section 751(b) strips out unrealized receivables (which did not make it to section 736(a)) and depreciation recapture. The gain from these items is then taxed to the selling partner as ordinary income. These payments, however, unlike the payments that go down to section 736(a) will not be deductible by the partnership.
- Payments that go from section 736(b) through section 751(b) and do not get stripped out by section 751(b) then make it to section 731 and constitute capital gain to the selling partner under section 741. The retiring partner deducts his or her outside basis from this amount. If none of the proceeds made it past section 736(a) and section 751(b) to section 731, then the retiring partner cannot use his or her outside basis and the partner would recognize a capital loss in the amount of the partner's outside basis.

Section 6166 Installment Plans

- Federal estate taxes are due nine months after a decedent's death.
- Under section 6166 of the Code if the value of a closely held business (as defined in section 6166(b)(1)) comprises more than 35% of a decedent's adjusted gross estate then the executor of the estate can elect to pay the taxes attributable to the value of the closely held business interest in up to ten annual payments.
  - The payments must begin within five years after the date that the estate taxes were originally due and can extend for up to ten years after such date, for a total of fourteen years of deferral.
  - If the payments of the tax do not begin until the fifth year, interest must be paid annually for the first four years.
  - There is 2% interest charged for the first $1,000,000 of value of a closely held business (indexed for inflation to $1,550,000 for 2019) included in the gross estate. Interest is charged on the balance of the taxes due at 45% of the regular rate charged by the IRS for underpayments under section 6621 of the Code, which is based on the Federal Short Term Rate plus three percentage points.

PULLMAN & COMLEY 100 YEARS

Succession Planning for The Successful Family Business

The Connecticut Bar Association Annual Conference

Presented By
Morris W. Banks, Esq.
Co-Authored by Kelly F. O'Donnell, Esq.

June 10, 2019

MORRIS W. BANKS
PULLMAN & COMLEY, LLC

- Morris W. Banks is a member of the law firm of Pullman & Comley LLC and practices out of the Hartford office. He served as an adjunct faculty member at the University of Connecticut School of Law from 1981 to 2016, teaching business planning. He is a graduate of Dartmouth College and Columbia University School of Law and holds a LL.M. degree in Taxation from the New York University Graduate School of Law. Mr. Banks has served as Chairman of the Hartford County Bar Association Committee on Liaison with the Internal Revenue Service, is the past Chairman of the Executive Committee of the Tax Section of the Connecticut Bar Association and currently serves on the Executive Committee of both the Tax Section and Business Section. He is a frequent lecturer on tax-related subjects, with particular emphasis in merger and acquisition transactions and succession planning for closely held businesses. He is a past President and chairman of the Connecticut Opera Association and has served as the President and as a board member of the Greater Hartford Arts Council. Mr. Banks was presented with the lifetime achievement award by the Connecticut Law Tribune in 2017.

KELLY F. O'DONNELL
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- Kelly F. O'Donnell is an associate in the Business Organizations and Finance and the Trusts and Estates practice areas. In the corporate arena, Kelly works with businesses of all sizes and assists start-ups with understanding the legal requirements necessary to run their operations. Her practice includes mergers and acquisitions, contract review and negotiation, corporate formation, customer and vendor agreements and negotiations, protection of intellectual property, corporate succession planning and tax planning advice.
- As a member of the firm's Trusts and Estates practice, Kelly advises clients regarding business succession planning, health care decision-making, and estate planning. Kelly also engages in probate litigation involving both family disputes and business issues.
- Kelly is currently pursuing her LL.M. in Taxation at Villanova University.

What is Business Succession Planning

- Process of creating and implementing a strategic plan
- Objective to integrate family needs with desire to assure continuity of business
- Consider personal, business, tax and liquidity issues
- Achieve short term successful operation of business
- Achieve longer term estate planning goals of the founder and long term viability of the business

Context of Discussion & Observations

- 90% of businesses are family controlled. They produce over 64% of U.S.G.N.P
- Only 1/3 of businesses survive the second generation and only 12% survive the third generation.
- Immortality of the founder.
- Reluctance to relinquish power.
- Reluctance to trigger sibling rivalries.
- Inheritance taxes are also a threat to the survival of the family business. However, the focal point of succession planning is not estate and tax planning, but complex family and emotional fall out.

Objectives

- Continuity – assure survival of the business at least through the second generation
- Determine how to blend family and business priorities
- Determine who will run the business
- Reduce transfer taxes
- Provide liquidity for estate; avoid a forced sale at founder's death
- Provide for adequate post-retirement income for founder and spouse
- Additional (and in some cases alternative) owner objectives
  – shifting wealth to children
  – reward employees
  – receive full value for business
  – take business to next level
  – maintain ownership indefinitely

Successful Planning Strategies

- Involving others in succession process – outside Advisory Board consisting of family members, professional advisors and sophisticated friends of the family
  - creates a vehicle whereby the capabilities of family members and others can be honestly evaluated
- Plan early
- Treat all children fairly – not necessarily equally
  - provide for fair distribution of assets to the children
- Transfer day-to-day management to those active in the business

Successful Planning Strategies (continued)

- Adequate training and preparation of successors. Development of leadership skills
- Each child's particular strengths should define his role in the business
- Transfer of ownership interest or possibly control to those active in the business
- Reduce or eliminate the interests of those siblings not in the business
- Determine how much if any control should be retained during the life of the Founder

Successful Planning Strategies (continued)

- Must deal with the conflict between family values and business values
  - create a meritocracy; necessity of demanding competency and high quality job performance
- Retaining key employees
- Preparation of a family charter
  - communicating with family members to enhance consensus
  - creating a family council
  - establish policies regarding the roles of those who participate in the business vis a vis the rights of those who are nonparticipating owners
- Corporate Governance – create a Board that includes non-family members with substantial business experience

Potential Solutions And Techniques (continued)

- Creating liquidity
  - sale of business during founder's lifetime
  - recapitalization - sale of a significant interest in the business
  - sale to an ESOP
  - life insurance payable to non-active children
- Dividing the business or its assets
  - isolating the real estate from the business
  - split off of separate lines of businesses or geographical locations
  - exploitation of new business opportunities in a separate entity

Potential Solutions And Techniques (continued)

- Bringing children into the business
  - integrating children into the business
  - assure that merit and not family loyalty is the key criteria for advancement
  - matching each child's skills and interests to his or her role in the business
  - outside work experience will enhance child's value to the family business
- Establish a management structure which delineates the functions of the surviving spouse, active children and key employees

Potential Solutions And Techniques (continued)

- Protection of Founder's spouse
  - when business interest should be bequeathed outright to spouse
  - when business interest should be included in the marital trust
    - independent trustee with authority over the business may be indicated
    - spouse may have to be given authority to cause a change of investments of the trust asset (the business interest) if not throwing off sufficient income
- Corporate redemption of stock
  - no deduction to corporate payor
  - tax treatment of redeemed taxpayer; waiver of the family attribution rules can be important to obtain capital gain treatment where there is a complete termination of interest under IRC Section 302(b)(3)

Potential Solutions And Techniques (continued)

- Sale of stock to children at fair market value
  - several goals accomplished:
    - transfer to children active in business while making cash available to non-active siblings
    - active children now have a financial stake in the success of the business
    - freeze value of business
    - provide retirement income to founder
  - installment sales
  - self canceling installment note (SCIN)

Potential Solutions And Techniques (continued)

- Segregating control from ownership
  - use of voting and non-voting ownership interests; potential problems
  - protecting minority and non-voting interests from abuse of power; use of voting trust to hold controlling interest with a super majority of non-controlling interests having the right to remove the controlling stockholder(s) as trustee(s)
  - use of debt instruments
  - use of preferred stock
  - adoption of the foregoing approaches in a limited liability company or limited partnership setting

Potential Solutions And Techniques (continued)

- Providing incentives for key employees
  - Employment agreements
  - Phantom stock plan
  - ESOP

Potential Solutions And Techniques (continued)

- Gifting of company stock during life of Founder
  - outright transfer to family members
  - net gifts of business interests; part sale, part gift
  - family limited liability companies and family limited partnerships as vehicles to effect transfers to family members
    - maintaining control
    - minority discounts and illiquidity discounts
    - successor manager or shift in control of general partner upon death of founder
    - impact of *Strangi*, *Kimbell* and *Hackl*.

Potential Solutions And Techniques (continued)

  - use of annual exclusion
  - state and federal gift tax exemptions
  - trade off of loss of step up in basis at death of Founder vs. keeping appreciation in value of interest out of Founder's estate
- Intentionally Defective Grantor Trusts ("IDGT") can be useful in both the gift and sale contexts
  - completed gifts while transferor continues to pay the tax on the income
  - No gain to Grantor if a sale to the IDGT. The installment payments of the purchase price made to the Grantor provides liquidity in his or her retirement years and are received tax free by the Grantor.

Potential Solutions And Techniques (continued)

- Transfers taking effect at death; Buy/Sell Agreement
  - provide for purchase by active family members or entity purchase
  - establish date of death value.
  - provides liquidity to estate of deceased Founder
  - funding of purchase
    - life insurance
    - accumulated earnings
    - post death pay out
- Providing for liquidity for payment of estate taxes

Potential Solutions and Techniques

- Use of life insurance
  - Second to die policy
  - Owner must avoid having "incidents of ownership" in policy
  - Life Insurance as a vehicle to fund Buy/Sell Agreement
- Deferral of taxes under IRC Section 6166 and coordination of redemption installment payments so as to avoid acceleration of taxes otherwise deferred under Section 6166

Case Study

Pre-planning

- Family business $60M annual revenue
- Value $8-10 million
- Founded by Dad now in sixties
- Dad and two children active in business
- Mother and three children not active
- Related general partnership owns business real estate leased to the corporation and is owned equally by the five children

Case Study

- Two classes of common stock, voting and non-voting
- The two active sons in business for about 15 years
- Relationship with father and each other excellent
- Oldest son has assumed most of the leadership and has functioned as President and has assumed administrative, financial and strategic planning role

Case Study

- Other son is on the production side of the business, particularly purchasing and marketing. He defers to his older brother on most business issues outside of his immediate area.
- Both brothers perform their jobs very well.
- Dad has continued to maintain voting control. He has also given voting and non-voting common stock not only to the active siblings, but also to the inactive siblings such that the inactive siblings were holding 26.4% of the voting stock and 43.74% of the non-voting common stock or a total of 42% of the total voting and non-voting common stock while the active siblings had only 6.9% of the voting common stock and 30.3% of the non-voting common stock, a total of 28% of the total voting and non-voting common stock.
- Potential for a substantial estate tax upon second to die of mother and father, plus confusion concerning overall control of the business going forward.

Case Study

The Plan

- Redemption of stock of siblings and mother.
- Father and active sons exchange stock so as to result in 50/25/25 shared voting control.
- Active sons increased their percentage of total equity from 28% to 68.55%.
- Redemption paid for by long term notes subordinated to Bank debt.

Case Study

The Plan

- Father's estate plan leaves both voting and non-voting common stock held by father at his death to all children equally. Stock held in marital deduction trust until death of wife. This will result in active sons holding an aggregate of 80% of total equity in company and gives them voting control over the Company.
- Permits non-active children to share in possible increase in value of company over time to a limited degree while they are also receiving principal and interest on deferred payments.

Case Study

The Plan

- Real estate general partnership converted to a limited liability company with active sons functioning as managers, but with limitations on their authority with respect to leases to the family business as a tenant.
- $3 Million second-to-die policy on founder and spouse's lives owned by LLC to provide liquidity upon their deaths.
- Deferred Compensation Agreement provides that father will receive after retirement $125,000 per year for his life after retirement.
- Use of marital deduction to defer taxes until death of surviving spouse.

Stock Ownership Prior and Subsequent to Redemption

STOCK OWNERSHIP OF COMPANY IMMEDIATELY PRIOR TO AND SUBSEQUENT TO THE PROPOSED REDEMPTION								
	PRIOR TO REDEMPTION				SUBSEQUENT TO REDEMTPION			
	1	2	3	4	5	6	7	8
	Voting Common Stock	Percentage Ownership of Voting Common Stock	Non-Voting Common Stock	Percentage Ownership of Non-Voting Common Stock	Voting Common Stock	Percentage Ownership of Voting Common Stock	Non-Voting Common Stock	Percentage Ownership of Non-Voting Common Stock
Name of Shareholder								
Founder	1,864	60.00%	2,646	9.60%	1,834	89.60%	2,646	24.00%
Founder's Spouse	206	6.70%	3,661	13.30%	0	0.00%	0	0.00%
Active Son 1	106	3.45%	4,172	15.20%	106	5.20%	4,172	38.00%
Active Son 2	106	3.45%	4,172	15.20%	106	5.20%	4,172	38.00%
Inactive Sibling	268	8.80%	4,011	14.58%	0	0.00%	0	0.00%
Inactive Sibling	268	8.80%	4,011	14.58%	0	0.00%	0	0.00%
Inactive Sibling	268	8.80%	4,011	14.58%	0	0.00%	0	0.00%
Grandchildren Trust	0	0.00%	820	3.00%	0	0.00%	0	0.00%
Totals	3,056	100.00%	27,504	100.00%	2,046	100.00%	10,990	100.00%

Shares To Be Redeemed

Shareholders	Number of Shares Redeemed	Total Purchase Price	Down Payment	One Year Note	Long-Term Note
Founder's Spouse	3,867	$1,091,000	$41,000.00	0	$1,050,000
Inactive Child	4,279	1,207,000	57,000.00	0	1,150,000
Inactive Child	4,279	1,207,000	57,000.00	0	1,150,000
Inactive Child	4,279	1,207,000	57,000.00	0	1,150,000
Irrev. Trusts for Grand-children	820	231,000	0	231,000	
Totals	17,524	$4,943,000	$212,000.00	$231,000	$4,500,000

Shares Held Before and After Exchange

- Father exchanged 406 of his voting common stock for 406 shares of non-voting common stock held by each son so as to result in shared control [50%/25%/25%]
- Total voting and non-voting shares are held approximately 1/3 each

	Shares Held Prior to Exchange						Shares Held Subsequent to Exchange					
	Voting		Non-Voting		Total		Voting		Non-Voting		Total	
		%										
Founder	1,834	89.6%	2,646	24%	4,480	34.4%	1,024	50%	3,456	3.145%	4,480	34.370%
Active Son 1	106	5.2%	4,172	38%	4,278	32.8%	512	25%	3,766	34.275%	4,278	32.815%
Active Son 2	106	5.2%	4,172	38%	4,278	32.8%	512	25%	3,766	34.275%	4,278	32.815%
Totals	2,046	100%	10,990	100%	13,036	100%	2,048	100%	10,988	100%	13,036	100%

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Succession Planning For The Successful Family Business

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Introduction

This article will discuss the family succession planning process in general and then apply the general planning strategies, solutions and techniques to the case study at the conclusion of the article to solve a specific business succession situation.

Business succession planning is a two-pronged process:

First, we must deal with intra-family issues. Here we are functioning more as psychologists than as tax or estate planning professionals.

Then, if we can resolve these intra-family issues, we can take the next step and propose a series of legal and tax-driven methods or techniques to satisfy the family's objectives which, if we are successful and if the family cooperates, will give us the best shot that the business will survive and even thrive into the next generation.

Context of Discussion and Observations

There is a macro economic aspect to this whole process. Ninety percent (90%) of all businesses in the United States are family controlled. They produce over sixty-four percent (64%) of the nation's gross domestic product generate sixty-two percent (62%) of the nation's employment, and account for seventy-eight percent (78%) of all new job creation.[1] Therefore, the continued vitality of these businesses has a profound impact on the United States economy, including employment. However, only one-third (1/3) of these businesses survive the second generation and only twelve percent (12%) the third generation.

[1] Statistics provided by the Conway Center for Family Business.

In many instances, one of the greatest barriers to even commencing the process is the perceived immortality of the founder. The founder believes he will always be around to either run the business or to give guidance to the next generation. Combine that with a reluctance to relinquish power and then throw in a reluctance to trigger sibling rivalries by not dealing with the relative competence of the family members who may be active or might become active in the family business, and we suddenly see we are dealing with a powder keg that in the aggregate has national economic and social implications, and we haven't even broached the subject of taxes or legal structure. Although inheritance taxes are also a threat to survival of the family business, the focal point of succession planning is not estate and tax planning but rather complex family issues and the emotional fall out that results.

Overall Approach to Family Business Succession Planning

Ultimately, it is of paramount importance to determine the desires of the founder regarding the transitioning of the business. Is there a willingness to transfer ownership and if so to whom and when; and then is there a willingness to transfer control as well, or just ownership; or if there is a reluctance, what is the professional's role in assisting and advising the founder with respect to modifying his behavior if we believe that his reluctance to transition will threaten the survival of the business to and through the next generation?

Our first objective is to ensure the survival of the business at least through the next generation. We must determine how to blend family and business priorities. We must determine who will run the business and who will perform the various tasks to assure its success.

Then we shift to the tax and business strategies to be adopted to get the business to the next generation.

We want to reduce transfer taxes and if necessary provide liquidity for the estate and by all means avoid a forced sale at the founder's death.

In addition, a successful business should be able to afford to fund adequate post-retirement income to the founder and his spouse.

But the owner's objectives can be far more complex than shifting wealth to the children. He should also be concerned about rewarding non-family key employees and keeping them on board. He may decide to cash out in the midst of all this which means selling the business. This could be a decision made either by the founder or the next generation no matter how committed they would appear to be to the business. If the family wants to take the business to the next level, they might well bring in a private equity fund to cash out the founder or to have all the family members take some money off the table and at the same time provide additional working capital to bring the business to the next level: expansion, new stores, etc.

Or perhaps the founder's objectives are more family focused, that is, he wants the family to maintain ownership indefinitely.

One size does not fit all in the succession planning process. Every family's objectives will be different and in many cases they are valid objectives; and our job as professional advisors is to make sure we understand the founder's and the family's objectives and to be both flexible and knowledgeable enough to be able to assist a family in achieving those objectives in a tax-efficient manner, and when necessary to give firm guidance when it becomes apparent that the founder is heading down the wrong path.

We will be focusing on a number of planning strategies to achieve those objectives.

Successful Planning Strategies

It is important that the founder be convinced that involving others in the succession planning process can be salutary. We must convince our client that an advisory board should be assembled consisting of family members, the family lawyer or a specialist in this area, the company's accountants and perhaps even knowledgeable and sophisticated family friends. This creates a vehicle whereby the capabilities of the family members and others can be honestly evaluated and in fact takes mom and dad off the hook when dealing with the children such that if sibling rivalries do arise, at least mom and dad are not in the middle.

The succession planning process should start early, that is, do not wait until dad is ill or suffering from a disabling or terminal disease. Start the process while the children are still young and can be trained to assume the appropriate positions and to perform the appropriate functions in the business while mom or dad is still around to provide guidance when necessary.

Now this is key. The children should be all treated fairly not necessarily equally; that is, the children active in the business may receive transfers either inter-vivo or testamentary of interests in the business, while the other children would receive other assets. (Assuming, of course, that there are other assets available to give to those children).

Or, perhaps it would be deemed a fair distribution of assets to the children to give those active in the business voting interests in the business while those not active non-voting interests. The decision whether the non-active siblings should be receiving non-voting interests or no interest whatsoever is a difficult one and is going to be based upon the dynamics of a particular family, as well as whether other assets exist that can be transferred to the non-active siblings. Clearly, most children who are active in the business do not want to share the results of their efforts with those who are inactive, and they certain don't want to share control. We will deal more with that in a moment.

It should be unnecessary to state the obvious that it is most important that the day to day management of the business be transferred as early as possible to those children who are active in the business. This is not a matter of ownership but rather a matter of mom or dad backing off and letting those children in the business assume positions of authority whereby they can make decisions that are not second-guessed by dad. If the transitioning process starts early, the active children will grow into their positions while mom or dad is still available for consultation and guidance, if necessary. This process will hopefully result in the active children exercising real authority in running the business and making informed and intelligent business decisions.

Creating a Meritocracy

The advisory board should work with the founder to create a meritocracy, that is an entity that demands competency and high quality job performance. This is where the rubber meets the road because this is not the usual family paradigm. As part of that, each child's particular strengths should define his role in the business. An obviously example is a child who is an accounting major should not be employed in the marketing side of the business, but rather should be a candidate for the CFO job.

As indicated previously, it is up to the founder to decide when, how much and the nature of the transfers of the interest to the next generation. His objective should be to reduce or eliminate the interests of those siblings not in the business, and/or not capable to manage or even be a participant in the business. And lastly, Dad must determine how much control should be retained by him and for how long, and to whom it will be transferred, and how that decision impacts on the mindset of the active siblings and on the entire succession planning process.

Retaining key employees is of great importance. Many businesses are highly dependent upon non-family member key employees who contribute substantially to the success of the business and who will continue to do so after the second generation is running and even controlling the business. The process cannot ignore this important aspect of the successful transitioning of the business to the next generation. We will discuss appropriate techniques to satisfy these key employees later in this article.

Potential Solutions and Techniques

Assuming that we have dealt with the intra-family issues and have the right framework and frame of mind amongst family members, we must now deal with economic and tax issues.

Providing for Liquidity

Is the founder in need of cash? If so, then the creation of liquidity should take place during the founder's life rather than upon his death.

The sale of the business during the founder's life time is simple and creates the opportunity for the entire family to cash out.

A recapitalization resulting in the sale of a significant interest in the business gives the family members, particularly the founder, the opportunity to take some money off the table.

The founder may sell a portion or all of his stock to an Employee Stock Ownership Plan ("ESOP"). An ESOP is a qualified retirement plan which is designed to invest primarily in qualifying employer securities. If a founder sells stock in his or her C corporation to an ESOP and, after the sale, the ESOP owns at least thirty percent (30%) of the company, then the founder can defer the income tax on the gain on the sale by reinvesting the cash received in securities of United States operating companies. The deferral continues so long as the founder holds the replacement securities. If the replacement securities are held until the death of the founder then the gain realized by the founder on the sale of the shares to the ESOP is never taxed. In the case of an S corporation, LLC, or partnership, no deferral is possible and the seller recognizes a capital gain upon sale of the stock to the ESOP unless the entity converts to a C corporation prior to such sale.

An ESOP may leverage the purchase, that is it may borrow the funds necessary to purchase the stock from an institutional lender, which may require that the loan be guaranteed by the company or by the selling shareholder. Alternatively, the company may borrow from a bank and re-lend the funds to the ESOP. The ESOP will then apply the funds to the purchase of the stock from the founder. The company contributions made to the ESOP in order to provide funds to repay the loan are deductible, the interest up to thirty percent (30%) of EBITDA[2] and the principal component of the loan up to twenty-five percent (25%) of the eligible wages of ESOP participants. In the case of an S corporation, contributions made by an S corporation to pay ESOP loan interest will count against the twenty-five percent (25%) of compensation deduction limit. ESOPs are now permitted to be the owners of S corporation stock, and an ESOP may be especially attractive in the S corporation setting. The taxable income that flows through to the shareholders of an S corporation is not taxable to the ESOP as a shareholder because the ESOP is exempt from tax, being a qualified plan. So there are a number of advantages to using an ESOP, and it gives the founder a method of cashing out.

If the founder does not need liquidity during his life, then another way of creating liquidity is to provide for life insurance payable to the non-active children which will serve to compensate them for their not having an interest in the business.

A further method for providing assets to children that might be more liquid than the business and to provide annual income is to isolate the business real estate from the business. This provides an excellent opportunity by way of rental payments by the business to get cash on an annual basis to the founder (to provide retirement income) or to the inactive children as a method to compensate them for the transfer of the business to the active siblings. This is really a structure which should be used from the inception of the business. Real estate owned by a corporation is difficult if not impossible to spin off on a tax deferred basis under Section 355 of the Code because the five (5) year active business requirement cannot be satisfied with real estate.

However, in appropriate situations, a Section 355 spin off or split off can be an excellent method of dividing the business or its assets by business segments or business geographical locations. Also, a new entity may be formed to exploit a new business development or opportunity, particularly where there is excellent growth potential. These techniques create opportunities or solutions when it is necessary for siblings to go their separate ways. Each child can exploit his or her own business if that is preferable to working together with his or her siblings in a unitary business or if a younger child's entry into the existing business is resisted by his or her older siblings who do not want to suffer dilution of the value that has been built up in the business due to their hard work.

The corporate redemption of stock is a technique that was used in our case study. Under the right circumstances, this is an excellent method of increasing the percentage interests of the active siblings while at the same time getting cash out of the corporation to provide liquidity both to the founder and to the founder's spouse as well as to inactive siblings (obviously, thereby reducing or eliminating any interest held by the inactive siblings). The payments made in redemption of stock are not deductible by the corporation, but if you can satisfy the so-called "redemption rules" of Section 302(b), as impacted by the attribution rules of Section 318, the cash received by the various family members will be subject to capital gains treatment, yielding a fifteen percent (15%) tax on the long-term capital gain unless the taxpayer is in what was

[2] In 2022, the limit on net interest deductions decreases to thirty percent (30%) of EBIT.

formerly the 39.6% tax bracket[3] in which case the rate on capital gains rises to twenty percent (20%). Installment sale treatment is also available if installment notes are issued by the redeeming corporation, thereby conserving corporate cash, while permitting the selling shareholders to defer recognition of gain while receiving interest income on the principal of the notes unreduced by the tax thereon.

Bequests of Business Interests to a Surviving Spouse

When the business constitutes a large part of the founder's estate, it may be necessary for estate planning purposes that at least some portion of the business interest still held by the founder at his or her death be either bequeathed outright to the surviving spouse or included in the marital trust. That is, to the extent that the unified gift and estate tax credit equivalent of $11,400,000 in 2019 is exceeded by lifetime gifts plus the assets of the first to die spouse held at death, assets passing at death to persons other than the donor's spouse will be subject to the federal estate tax. That would mean that in many cases it will be necessary for a decedent's business interest to be bequeathed to the decedent's wife or a trust for her benefit to avoid taxes on the first death. This is an obvious complication if the decedent's objective is to assure that his interest in the business goes to his children who are active in the business.

If the spouse has been involved in the business and is capable of running it, then an outright bequest might be appropriate. Otherwise, the business interest should be included in the marital trust where an independent trustee or trustees with authority over the business may be desirable. If the marital trust will be holding a controlling interest, it may be important that the trustee, in fact, not be independent, but rather the siblings active in the business be given at least voting authority over the stock in the trust even though other non-family trustees may be given authority with respect to the distribution of income and/or principal out of the trust.

A qualified terminal interest property ("QTIP") trust may be necessary in order to assure that the stock, particularly voting stock, will continue to be held for distribution to the active siblings as remainderman upon the death of the surviving spouse rather than the possibility that such stock could either be distributed to the surviving spouse during his or her life or be subject to a testamentary power of appointment such that upon his or her death it would go elsewhere, such as to the inactive siblings, which would probably not be consistent with what the founder wanted and might threaten the success of the family business going forward.

Now with portability, that is the ability to have the unused credit equivalent of the first spouse to die being available for use in calculating the tax upon the death of the second spouse, with good planning a couple's taxable estate will have to exceed $22,800,000 before a federal tax is attracted. However, it is important to remember that Connecticut's estate tax exemption is *not* portable and therefore titling of assets may be critical for family business to maximize both parent's estate tax exemptions.

[3] Taxable income for single filers above $434,500; for married filing jointly over $488,850.

Sale of Stock to Children

The sale of stock to the children rather than transfer by lifetime gift seems counter-intuitive inasmuch as it imposes obligations on the children to make the payments to the founding parent and the founding parent ends up with the value of those payments in his or estate. However, several goals are accomplished:

- The stock is transferred to the children who are active in the business while making cash ultimately available to non-active siblings.

- The active children now have a financial stake in the success of the business.

- The sale of stock to the children freezes the value of the business as of the date of the sale, thus potentially resulting in a substantially lesser transfer tax to the founder while increases in value attributable to the activities of the active siblings inure to their benefit. Installments sales to the children are permissible and will permit the founder to defer payment of the capital gains tax on the sale until the cash is received. If the founder dies before the note is paid, then the value of the note will be included in his or her estate. While the founder is living, the payments to the founding parent provide another source of retirement income for his or her benefit.

- The use of self-canceling installment notes or "SCINS" should be considered under these circumstances. A SCIN is an installment note that is cancelled automatically on the death of the seller. If the seller dies before the end of the term, the unrecognized gain on the sale is accelerated, but the unpaid portion of the note is <u>not</u> included in the estate of the seller (the founding parent). Also, no cancellation of indebtedness income is recognized by the buyer who issued the note upon its cancellation. The promissory note must provide for a risk premium for the self-canceling feature in addition to the AFR to qualify as representing full and adequate consideration for the sale of the stock by the noteholder.

Inter Vivos Gifts of Stock to the Children

The other side of the coin to the sale of stock by the founder to his or her children in various forms is the outright gifting of the company's stock during the life of the founder.

This starts moving more into the realm of traditional estate planning rather than business succession planning, although the motivations are certainly succession planning, while the results of such gifts should be analyzed from the standpoint of the overall estate plan of the founder or transferor.

Let's review the bidding: with respect to the federal estate and gift taxes, the federal estate tax exemption for 2019 is $11,400,000.

Under current legislation, the federal gift tax which is unified with the estate tax is also $11,400,000. The amount of any gift in excess of $11,400,000 will attract tax to the extent that such gift exceeds the annual exclusion amount. The annual exclusion for 2019 is at $15,000 but will increase based upon a cost of living adjustment in future years. Use of split gift provisions with one's spouse can double these exemptions.

For federal purposes, taxable gifts are included in the estate tax base and the determination of the size of the estate subject to the estate tax such that the first $11,400,000 of gifts will be not subject to tax because of the unified credit.

For Connecticut purposes, the Connecticut estate tax exemption and also the Connecticut gift tax exemption for the year 2019 is $3,600,000 and under current legislation that figure shall increase dramatically over the next few years until it matches the federal estate tax exemption. The federal annual exclusion will also apply to Connecticut gifts.

Accordingly, all gifts of stock made by the founder must take into account the transfer taxes that are generated by such a gift. The gifts can take on a number of different forms:

- Outright transfer to family members. This is fairly straight forward and such gifts may be subject to illiquidity discounts and minority interest discounts.

- Net gifts of a business interest are considered part sale and part gift. In a net gift arrangement, a donor agrees with the donee that the donee will pay the donor's gift taxes that become due by reason of the gift. The appraised value of the donor's stock, reduced by illiquidity and minority interest discounts, would be further reduced by the amount of the gift tax payable by the donees. That is to say, the donees are making a payment on behalf of the donor in the amount of the gift tax, thus reducing the amount of the gift. A complex formula is necessary to determine the amount of tax thus due.

  The payment of the gift tax results in the transfer by the donor being treated partially as a gift and partially as a sale. The entire tax basis of the stock being transferred may be allocated to the sale portion of the transfer and the sales price is the amount of tax being paid by the donee. The gain to the donor, therefore, is the difference between the amount of the tax being paid by the donee and the entire basis of the stock subject to the transfer which would no doubt be a long term capital gain to the transferor. The question then arises as to who pays the capital gains tax of the donor. If the donee pays the capital gains tax, this will be treated as a gift by the donee to the donor. To the extent that any of the parties are married, they can use the split gift provision in order to potentially reduce the amount of the gift tax owing in both directions.

Intentionally Defective Grantor Trusts ("IDGT")

- An IDGT is a type of trust which is drafted in such a manner as to assure that the transfers to the trust (generally for the benefit of the children of the grantor) qualify as completed gifts for gift tax purposes. However, because of the retention of one of more powers by the donor, such as the power to reacquire the trust assets by substituting other property of an equivalent value, the income of the trust post transfer will be reported by the grantor, and he or she will be paying the tax on that income even though by the terms of the trust the income goes to his or her children (which is the grantor's intention). The bottom line is that the children are in effect receiving an annual gift (not subject to the gift tax) in an amount equal to the income taxes attributable to the annual income payable to the children.

Also, an IDGT is useful in the case of a sale of the business interest to the trust. Inasmuch as the founding parent is deemed the owner of an IDGT for tax purposes, he or she will pay no capital gain tax on the sale of the business interest to the trust since for tax purposes only, the founder is deemed to have sold the stock to himself or herself, yet the founder's children are paying him or her the purchase price (perhaps over a number of years in the case of an installment sale) that gives the founder sufficient liquidity to maintain his or her lifestyle over a protracted period of time. To assure this tax treatment, it is advisable that the trust be "seeded" with cash or other liquid assets in an amount equal to at least ten percent (10%) of the value of the business interest sold to the trust, and that the beneficiaries of the trust personally guarantee any promissory note issued to the grantor in payment for that business interest.

- The use of family limited liability companies and family limited partnerships as vehicles to effect transfers of business interests to family members have been under constant treasury attack. The IRS published Proposed Regulations of August 4, 2016 that would have eliminated most illiquidity and minority interest discounts in connection with family controlled entities but these Proposed Regulations were withdrawn in October of 2017. However, as a result of the *Strangi* and *Kimbell* cases, the transferor must be very careful that the transferred business interests are not thrown back into his estate under Section 2036(a) of the Code which relates to the transfers with a retained life estate. This includes the retention by the donor of the possession or enjoyment of the right to income from the property which in turn includes the retention of the right to vote, either directly or indirectly, the shares of stock of a controlled corporation. Maintaining control over the limited liability company as manager or under the limited partnership as a general partner will no doubt be construed as maintaining such voting control. An exception to this treatment would be if the transfer by the donor of the stock to the LLC or the limited partnership would be considered a bona fide sale for an adequate and full consideration in money or money's worth in which case Section 2036(a) no longer applies. In order for that to occur, the interest received in the LLC or limited partnership in exchange for the stock must be considered adequate and full consideration for money or money's worth for the transfer of the business interest. Under *Strangi* and *Kimbell* and their progeny, although the transfer to an LLC or to a limited partnership of a portfolio of marketable securities is particularly vulnerable, a transfer of a closely held and actively managed business interest should be deemed a bona fide sale and result in the successful avoidance of Section 2036(a).

> Under *Hackl*, the availability of annual exclusions may be lost where the donor acting as the manager or managing partner can determine whether or not annual income will be available to the holders of the limited partnership interests or membership interests. Under such circumstances, gifts of these interests will not be characterized as "present interests," a prerequisite to qualifying for the annual exclusion. This result can be avoided by giving the donee a put option to have his interest bought out for a period of thirty (30) days after the transfer, thus incorporating the Crummy concept into the transfer.

Testamentary vs. Inter Vivos Gifts

In order to determine whether a testamentary gift or inter vivo gift of stock to the next generation should be advised involves an analysis of the trade-off of the loss of the step up in the basis at death if the founder enters into a program of inter vivos gifts (which would keep the appreciation in value between the date of the gifts and the founder's death out of his estate) vs. retaining the interest until his death and then bequeathing it to his children, resulting in the beneficiaries getting the advantage of a step up in basis to the date of death value, but the inclusion of that increase in value in the decedent's estate. Since none of us have a crystal ball, it is very hard to determine what the value might be at the date of death of a donor, and how much the estate tax exemptions, both state and federal, might be at that time. With the recent increase in the federal estate tax exemption, families may be in a better position to explore the benefit of a step-up in basis on death without worrying about triggering an estate tax.

Buy-Sell Agreement

In a sense, the last chance for any succession planning is upon the death of the founder. Although the founder may have the appropriate asset mix so that he or she can make bequests of his or her business interest to the children who are active in the business while adequately providing for his spouse and non-active siblings with other assets, such might not be the case. Under those circumstances, the transfer taking effect at death could be structured as a buy-sell agreement, most likely a redemption agreement whereby the corporation would purchase the stock from the estate of decedent for either cash or installment obligations. A properly drafted buy-sell agreement will establish a date of death value and provide the appropriate liquidity to the estate of the deceased founder in order to both pay taxes, if there be any, and to provide cash to make the appropriate bequests to other surviving family members, that is the spouse and other children.

The purchase can be funded either by the accumulated earnings of the company or life insurance. Presumably, in a redemption agreement, the corporation will own the life insurance and will be the beneficiary of such policy. All or most of the proceeds will then be applied toward the purchase of the decedent's stock.

In the alternative, absent life insurance, and if the corporation does not have sufficient liquidity to pay cash for the decedent's stock, the corporation can issue installment obligations to the decedent. This raises a host of other problems including those arising from banking relationships whereby the issuance of such installment obligations may be prohibited under current financing arrangements. Indeed, the purchase of the stock for cash might very well also be prohibited under the standard negative covenants in bank documents. Under any circumstances, such notes should provide for subordination to any bank or other institutional indebtedness.

Deferred Payment of Federal Estate Tax

At the beginning of this article I indicated that succession planning was really less about the liquidity needs of the founder to pay death taxes than other considerations. However, Section 6166 of the Code provides important relief to a large number of estates where the stock of the business held by the estate constitutes more than thirty-five percent (35%) of the decedent's adjusted gross estate. If that requirement is satisfied, then the decedent's estate may pay the taxes attributable to the value of the business interest over a fifteen (15) year period. In addition, the payment of the taxes can be deferred during the first five (5) years whereby the estate pays interest only to the U.S. Treasury at a fairly low rate and only thereafter from the fifth (5^{th}) to the fifteenth (15^{th}) year are the taxes paid in ten (10) equal installments, together with interest on the unpaid balance.

In the event that a redemption agreement exists between the decedent and the company or a cross purchase agreement between the decedent and his surviving siblings which provides for payments in installments, the installments must be paid in such a manner so as to assure that the payments under Section 6166 are not accelerated. By careful draftsmanship, the installment payments can be coordinated with the amounts otherwise payable under the deferral provisions of 6166, thus avoiding any acceleration, but at the same time providing a portion or all of the liquidity with which to pay such taxes.

Satisfying Key Employees

Employment contracts are the primary method of giving key employees comfort and according them the security necessary to assure their continued loyalty.

A phantom stock plan or stock appreciation rights plan (SAR) are arrangements whereby the increased value of the entity is reflected in the amount which key employees realize when the business is sold or undergoes an organic transaction. This will be viewed by key employees as a reward for their efforts in working with the family to enhance the value of the business while not transferring an actual ownership interest in the entity to the key employees.

These arrangements also represent a method of transferring value to non-active children. They would receive a portion of the proceeds on the eventual sale of the business. The issue that must be dealt with within the family, however, and most particularly with the active siblings, is whether they will be willing to share the largesse brought about by their efforts and those of the key employees with the inactive siblings.

A phantom stock plan or a stock appreciation rights plan will not constitute a property transfer to an employee under Section 83 and therefore will not constitute income at the time of such transfer. The employee will receive compensation income at the time that he receives payments or cashes in under the plan, usually upon the sale of the company or perhaps upon an event such as a death, disability, termination of employment or retirement of the employee. The important thing to remember, however, is that such a plan will not result in any income to the employee, compensatory or otherwise, at the time of the grant of the right.

We have already discussed an ESOP as a means of providing liquidity to the founder. It also accomplishes another objective providing an interest in the business to key employees.

Case Study

Now, let us take a look at the case study and see how what we have discussed was or was not followed by the family in its succession planning.

The family business was generating about $50 million of annual revenue. Its value was appraised at $9 million and the business was earning approximately $1.5 million per year as a Subchapter S corporation. The family was taking out good salaries but not huge by today's standards.

Dad was still active in the business. However, two (2) out of the five (5) children that were active in the business were given substantial amounts of authority to perform important functions for the business early on in their careers with the business. The younger of the two (2) active children was responsible for purchasing and the older of the two (2) active children was responsible for strategic planning and many of the financial affairs of the business. Dad was starting to slowly spend more and more time at his vacation home and while he was always available for consultation, he pretty much let the two active children run the business on a day-to-day basis. Dad also participated in strategic planning in terms of acquisitions and opening new units in order to expand the business. The two active children got along famously and both were very comfortable in their own skins and with each other and their respective responsibilities.

All the foregoing was a great credit to the way Dad brought up and nurtured his children.

So, it could be said that Dad did a fabulous job on the interpersonal side of the succession planning process in transferring managerial responsibilities to the children.

However, Dad did not do as good a job with respect to the ownership of interests in the business. One good thing he did, however, was isolate the company's real estate. The real estate occupied by the business in about a dozen locations was in a separate real estate partnership owned by the siblings. However, as a result of previous counseling, the ownership of the interests in the business were such that of the 3,056 shares of issued and outstanding voting common stock, the two active children together only owned 212 such shares (7%). Dad still owned 1,864 (60%) shares while the three inactive siblings owned 268 shares each, each more than both of the active siblings. This made no sense whatsoever.

Further, the non-voting common stock was owned in virtually equal shares by both the active and inactive siblings. The upshot of this was that although each of the active siblings owned approximately fourteen percent (14%) of the total of the voting and non-voting common stock, the same combined percentage was owned by each of the inactive siblings.

In consultation with the founder and the two active children, we developed a plan to redeem all of the stock, both voting and non-voting, held by all of the inactive siblings, and the founder's spouse. This was accomplished by virtue of the issuance of some cash, but mostly promissory notes of the company. Very substantial attribution problems had to be overcome in order to qualify each one of these redemption distributions for capital gain treatment under Section 302 of the Code. This transaction took place during the bad old days when there was a substantial difference between the rate applicable to dividends (which was the same rate as ordinary income) and the twenty percent (20%) tax rate applicable to long-term capital gains. It was important that each one of these redemptions qualify for capital gain treatment. The attribution rules were so unique that we applied for a private letter ruling. The government also thought they were unique enough such that the favorable private letter ruling was published in the Cumulative Bulletins and picked up in a number of publications.

The inactive siblings continued to hold significant interests in an LLC which owned the real estate that the company operated its business out of.

But that did not solve all of the issues. Although as a result of the redemptions, both Mom and the inactive siblings were effectively removed from the business, Dad still owned the lion's share of both the voting and non-voting common stock, most importantly 89.6% of the voting common stock.

The active children in this case not only felt that it was important for them to be able to not have to share the largesse of their hard work in building the business with their inactive siblings (as they would have to if Dad died owning such a large amount of stock to be distributed equally among his children), they also felt that it was important for them to be able to share control with their Dad.

After the redemption was completed, Dad agreed to an exchange of shares of his voting common stock for an equal number of shares of non-voting common stock held by the active children, thus resulting in Dad holding fifty percent (50%) of the voting common stock and each active child holding twenty-five percent (25%) of the voting common stock and Dad and the two active children each holding one-third (1/3) of the total equity in the Company.

The end game was really interesting. A few years later, the company was doing substantially better in terms of its EBITDA performance. By that time, the company's sales had increased to about $75 million and its EBITDA was approximately $12 million. The company was able to bring in a private equity capital firm which permitted Dad and the two active children to cash out a substantial portion of their respective holdings in exchange for approximately $63 million in cash. A substantial portion of this went to Dad who could then do what he wanted to do in order to protect the non-active children, but the active children were also able to realize on the results of the fruits of their efforts in building up the business. Very shortly afterwards, Dad made a net gift of his shares to the active children based upon an appraisal which took into account the fact that the purchase by the private equity firm of the company's business was substantially leveraged (there was a substantial amount of both senior and mezzanine debt to which the business was subject) which served to reduce the appraised value of the stock that Dad gifted to the two active children.

As it stands now, Dad no longer owns any interest in the business while the two active children each own approximately fifteen percent (15%) of the business and were able to pocket substantial amounts of cash proceeds upon the recapitalization involving the private equity firm.

This is the dream story with respect to business succession planning. The family did everything right. We, the advisors, gave what turned out to be very good advice (which was followed), the two active children did their share in running the business extraordinarily well (give an awful lot of credit of this to the father who adequately trained the children and did this in such a manner such that the two active siblings worked very well together to grow the business) and a decision was made at the appropriate time to sell a substantial portion of the business to the private equity firm.

We're not always that lucky with respect to all the components and all the constituencies coming together in the way that they did in this case. In any event, this does illustrate the excellent results that can flow from the application of the principles that were presented in this article.