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BUSINESS SUCCESSION PLANNING

by
JEROME L. WOLF, P.L.
DUANE MORRIS LLP
5100 Town Center Circle, Suite 650
Boca Raton, Florida 33486
Telephone: 561/ 962.2100

I. <u>INTRODUCTION</u>

A. TYPES OF ENTITIES TO BE CONSIDERED

1. Sole Proprietorship

(a) Simplest form of operating a business if there is only one owner.

2. General Partnership

(a) Simplest form of operating a business with more than one owner.

(b) In the absence of a written partnership agreement, the law of the state where the partnership is situated applies to the operation of the partnership. (Revised Uniform Partnership Act of 1995, Chapter 620, Part IV, Florida Statutes.)

3. Limited Partnership

(a) This is a form of business entity created by state law.

(b) In order to preserve the limitations on liability for certain partners, the statutory formalities of the Revised Uniform Limited Partnership Act in the entity's organization and operation must be complied with. (*See* Chapter 620, Part I, Florida Statutes).

(c) Limited partners must have no active involvement in the operation of the entity's business in a way that would cause them to be or perceived to be under the state's general partnership laws.

(d) An *LLP* is a general partnership that has registered as a "*limited liability partnership*" under Chapter 620 of the Florida Statutes. An LLP has the same qualities as a general partnership except that the liability of its general partners may be limited in certain circumstances.

(e) An *LLLP* is a limited partnership that has registered as a "*limited liability limited partnership*" under Chapter 620 of the Florida Statutes. An LLLP has the same qualities as a limited liability partnership except that the liability of its general partners (and its limited partners who may be deemed to be liable as general partners) may be limited in certain circumstances.

4. Limited Liability Company

(a) This form of entity is also created by state law (Florida Limited Liability Company Act, Chapter 605, Florida Statutes. An LLC may be structured as a general partnership, a limited partnership or a corporation, as the members may deem appropriate.

5. S Corporation

(a) An S corporation is a corporation for state corporate law purposes, but is taxed under Subchapter S of the Internal Revenue Code in a manner similar to a partnership for federal and Florida income tax purposes.

6. C Corporation

(a) A C corporation is a corporation for state corporate law purposes, but, in accordance with Subchapter C of the Internal Revenue Code, is subject to potential double tax consequences, at both the corporate entity and shareholder levels.

7. Combination of Entities

B. UNIQUE CHARACTERISTICS OF "FAMILY BUSINESS"

1. Family businesses are unlike most other assets encountered in the estate planning and administration process. They have a number of unique characteristics, which include the following:

(a) Limited market for its ownership interests;

(b) Lack of clearly identified successor management;

(c) Ownership by persons who are not active in the day-to-day operation of the business;

(d) Lack of formality in the governance of the entity;

(e) Difficult to establish a value for the enterprise and its parts;

(f) Ownership of the majority of the business is usually held by related persons; and

(g) Unusual mixture of tax consequences.

2. There are some general characteristics to be noted:

(a) Usually first or second generation management;

(b) Strong sense of identification with the business;

(c) Strong influence and control by a dominant individual;

(d) Family wealth is usually concentrated in the business itself;

(e) Resultingly, there is a lack of liquidity in the family wealth; and

(f) Oftentimes, management is determined by blood rather than merit.

3. The issues to consider in succession planning include:

(a) Transfer of the business interest among surviving spouse, children and possibly grandchildren upon death of the business owner.

(b) Transfer of business interests to non-active owners from those active in the management of the business upon death of the owner, and inheritance of the interest by the non-active descendants; or

(c) Transfer of business interests among the active participants in the business upon disagreement, retirement, disability or death.

4. The goals of the post-mortem administration plan are to accomplish the following objectives:

(a) To keep the business intact;

(b) To insure control of the business by those persons active in its operation;

(c) To treat all family members fairly, if not equally;

(d) To provide liquidity for the payment of all debts, estate taxes, administration expenses, and buy-out costs, if any; and

(e) To accomplish all this at a cash-flow cost which enables the business to continue without financial distress.

C. PLANNING CONSIDERATIONS

1. Nature and size of entity.

2. Value of the entity as a going concern.

3. Book value, market value, or other liquidation value of the entity's underlying assets.

4. Relative ownership interests of the owners.

5. Ages of the owners.

6. Financial condition of the owners.

7. Health and insurability of the owners.

8. Commitment of owners to the business and importance of their participation in the business.

9. Availability of assets for redeeming the interest.

10. State law with respect to stock exemptions in the case of a corporation or distributions to members of a limited liability company.

11. Existence of restrictions under loan agreements on the use of the entity's assets to redeem equity interests.

12. Family relationships among owners.

13. Working relationships among owners.

14. The extent to which the owners are active in the business and intend to remain active in the business.

15. Licensing or other qualification requirements.

16. Type of entity: C corporation, S corporation, personal holding company, professional corporation, general partnership, limited partnership, or limited liability company.

17. Conflicts of interest and ethical questions involved in representing or advising more than one owner and the entity, either when the agreement is negotiated or when an event occurs that causes the agreement to become operative.

II. CORPORATIONS

A. THE NUMBER AND TYPE OF SHAREHOLDERS

1. Shareholders. The number of shareholders an S corporation can have is limited to 100. *See* IRC §1361(b)(1)(A).

2. Grantor Trusts. A grantor trust (IRC §671 *et seq.*) can continue to qualify as an S corporation shareholder for a two year period **after the death of the grantor** whether or not the corpus of the trust is includible in the grantor's estate.

3. Testamentary Trusts. A trust that receives S stock under a will can continue to qualify as an S corporation shareholder during the two year period **which begins on the day the S corporation stock is transferred to the trust**.

4. Tax Exempt Shareholders. The Act permits organizations which are described in IRC §401(a) (qualified retirement plan trusts) or IRC §501(c)(3) (charitable organizations) and exempt from taxation under IRC §501 to be S corporation shareholders.

   (a) For purposes of the 100 shareholder limit a qualified tax exempt organization is counted as one shareholder.

   (b) An interest in an S corporation is treated as an interest in an unrelated trade or business. IRC §512(e)(1)(A). Items of income, loss, deduction or credit of the S corporation that flow through to the tax-exempt shareholder and gain and loss on the sale of such stock will be treated as UBTI. IRC §512(e)(1)(B).

5. Electing Small Business Trust.

   (a) An "Electing Small Business Trust" (an "ESBT") may hold an interest in an S corporation for long range planning. An ESBT can be a "spray" trust with multiple beneficiaries.

   (b) Interests in an ESBT may not be acquired by purchase. (An interest is acquired by purchase if the basis of the acquired property is determined under IRC §1012, *i.e.*, the property has a cost basis.)

   (c) An election must be made to qualify the trust as an ESBT.

      (i) The **trustee** makes the election for the trust to be treated as an ESBT.

      (ii) The election applies for the tax year in which it is made and for later years, unless it is revoked with consent of the Internal Revenue Service.

(iii) A trust must not have made a QSST election with respect to any stock held by the trust.

(d) A potential current beneficiary of an ESBT is any person who, at any time during the period, is entitled to (or at the discretion of any person may) receive a distribution from principal or income.

(e) Each potential current beneficiary of an ESBT is treated as a shareholder for the qualification requirements of the S corporation.

(f) If with respect to a period there is no potential current beneficiary, then the trust is treated as the shareholder during the period.

(g) The rule that each potential beneficiary of an ESBT is treated as a shareholder applies for purposes of the 100 shareholder limit.

(h) The portion of an ESBT which consists of stock of one or more S corporations is treated as a separate trust.

6. Qualified Subchapter S Trust.

(a) A qualified subchapter S trust ("QSST") is a trust which requires that:

(i) During the life of the current income beneficiary, there can only be one income beneficiary (thus, a spray or sprinkle trust for multiple beneficiaries cannot qualify);

(ii) Corpus distributions during the current income beneficiary's life can only be made to that beneficiary;

(iii) The current income beneficiary's income interest must terminate on the earliest of the current beneficiary's death, or the termination of the trust; and

(iv) If the trust terminates during the current income beneficiary's life, the trust's assets are all distributed to the current income beneficiary.

(v) The QSST election must be made by the **beneficiaries**.

(b) Additionally, all the trust's income (as defined under IRC §643(b) *e.g.*, corporate dividends) must be either distributed, or required to be distributed, currently to only one individual who is a citizen or resident of the U.S.

7. Wholly owned grantor trust.

(a) *See* IRC §§671, *et seq.* There are several methods available to design a wholly owned grantor trust that can avoid inclusion in the grantor's gross estate.

(b) *See* IRC §678. In comparison, if the transaction is structured properly a beneficiary can be treated as the owner of the entire trust.

III. <u>LIMITED PARTNERSHIPS</u>

A. The Definitions: It is important to understand the acronyms used:

1. FLP's: An FLP is a *family limited partnership* organized under Chapter 620 of the Florida Statutes. An FLP is a traditional limited partnership (*See* I.A.3., *supra*) and typically has a single general partner and one or more individual limited partners. Often times, the general partner is an S corporation or an LLC (referred to as a "Corporate general partner"). If the FLP is controlled by the corporate general partner, and ultimately by whoever owns or controls the stock or managing membership interests of the corporate general partner.

2. LLP's: An LLP is a general partnership that has registered as a *limited liability partnership* under Chapter 620 of the Florida Statutes. An LLP has the same qualities as a general partnership except that the liability of its general partners may be limited in certain circumstances. The LLP is not itself a form of enterprise. Rather, it supplements existing partnership and limited partnership law. General and limited partnerships, domestic and foreign, are eligible to register as an LLP.

(a) In 1995, Florida enacted the Florida Revised Uniform Partnership Act ("FRUPA") and repealed Florida's existing Uniform Partnership Act. Effective January 1, 1996, are of the principal FRUPA provisions relating to the formation and effect of LLP's Sec. 620.8306(3) setting forth the basic immunity of partners in an LLP from personal liability for partnership obligations.

(b) As a result of the 1999 amendments, general partners in registered LLPs enjoy the same immunity from personal liability as shareholders of a corporation. Inasmuch as creditors will only be able to recover from partnership assets, it is possible that equitable principles analogous to "piercing the corporate veil" will develop in partnership litigation.

(c) Rule 4-8.6 of the Rules of Professional Conduct of the Florida Supreme Court's Rules Regulating The Florida Bar authorizes the practice of law as an LLP.

3. LLLP's: An LLLP is a limited partnership that has registered as a *limited liability limited partnership* under Chapter 620 of the Florida Statutes. An LLLP

has the same qualities as a limited partnership except that the liability of its general partners (and its limited partners who may be deemed to be liable as general partners) may be limited in certain circumstances. A totally new limited partnership statute, repealing and replacing the existing statute was enacted in 2005 ("RULPA"), effective January 1, 2006.

B. Comparison of Limited Liability.

1. Partnership agreement:

The partnership agreement of a partnership can act similar to a spendthrift trust by preventing the partners from pledging their interest in such entity to secure debt or by preventing their interest from being seized by a creditor or a divorced spouse.

Example: "*No partner shall sell, assign, transfer, give, bequeath, devise, donate or otherwise dispose of, or pledge, deposit or otherwise encumber, in any way or manner whatsoever, whether voluntary or involuntary, any of his partnership interest now or hereafter owned (of record or beneficially) by him except as expressly provided in this Agreement and in accordance with its terms and conditions.*

The parties agree that the interests of the partnership and its partners would be seriously affected by any sale or disposition of any partner's partnership interest by any legal or equitable proceedings against such partner. Accordingly, it is hereby covenanted and agreed that in the event that (a) any partner shall be adjudicated a bankrupt or make an assignment for the benefit of creditors, or (b) bankruptcy, insolvency, reorganization, arrangement, debt adjustment, liquidation or receivership proceedings in which any partner is alleged to be insolvent or unable to pay his debts as they mature are instituted by or against such partner and, if instituted against such partner, such partner shall consent thereto or admit in writing the material allegations of the petitions filed in said proceedings or said proceedings shall remain undismissed for sixty (60) days, or (c) there is an entry of a decree or order for relief by a court having jurisdiction in the premises in respect of any partner in an involuntary case under the federal bankruptcy laws against any partner or any partner commences a voluntary case under such laws, or (d) any of the partnership interest of any partner is attached, or (e) any judgment is obtained in any legal or equitable proceeding against any partner and the sale of any of his partnership interest is contemplated or threatened under legal process as a result of such judgment, or (f) any execution process is issued against any partner or against any of his partnership interest, or (g) there is instituted by or against any partner any other form of legal proceeding or process by which any of the partnership interest of such partner may be sold either voluntarily or involuntarily, then in any such event the partnership and the other partners shall have options to purchase all, but not less *than all, of such partner's partnership interest in accordance with the following provisions hereof.*"

2. LLLP's:

(a) A *charging order* represents a lien entitling a judgment creditor to receive distributions from the partnership that would otherwise be payable to the partner who is the judgment debtor.

(b) F.S. 620.1703 "*Rights of creditor of partner or transferee. --*

(i) On application to a court of competent jurisdiction by any judgment creditor of a partner or transferee, the court may charge the partnership interest of the partner or transferable interest of a transferee with payment of the unsatisfied amount of the judgment with interest. To the extent so charged, the judgment creditor has only the rights of a transferee of the partnership interest.

(ii) This act shall not deprive any partner or transferee of the benefit of an exemption law applicable to the partner's partnership or transferee's transferable interest.

(iii) *This section provides the* **exclusive remedy** *which a judgment creditor of a partner or transferee may use to satisfy a judgment out of the judgment debtor's interest in the limited partnership or transferable interest.* ***Other remedies, including foreclosure on the partner's interest in the limited partnership or a transferee's transferable interest and a court order for directions, accounts, and inquires that the debtor general or limited partner might have made, are not available to the judgment creditor attempting to satisfy the judgment out of the judgment debtor's interest in the limited partnership and may not be ordered by a court.***" (emphasis added.)

3. LLC's:

(a) Similarly, the operating agreement can impose similar restrictions on the assignability or transferability of member interest.

(b) F.S. 605.0502 "*Transfer of transferable interest*.-

(1) ***Subject to s. 605.0503, a transfer, in whole or in part, of a transferable interest:***

(a) ***Is permissible***;

(b) Does not by itself cause a member's dissociation or a dissolution and winding up of the limited liability company's activities and affairs; and

(c) ***Does not entitle the transferee to****:*

1. ***Participate in the management or conduct of the company's activities and affairs; or***

2. ***Have access to records or other information concerning the company's activities and affairs.***

(2) ***A transferee has the right to receive, in accordance with the transfer, distributions to which the transferor would otherwise be entitled****.*

(c) However, the courts have held that utilizing a legitimate business structure for the sole purpose of shielding assets from creditors borders on a fraud on creditors.

(i) For example, in the bankruptcy case of *Movitz v. Fiesta Investments, LLC (in re Ehmann*), 319 B.R. 200, 206 (Bankr. D. Ariz. 2005), the bankruptcy judge held that the debtor's non-managing membership interest in an LLC, including the debtor's non-economic rights, may be the property of the debtor's bankruptcy estate.

(ii) This holding was despite Arizona law restricting the involuntary transfer of a member's LLC interest, which was deemed inapplicable under the Bankruptcy Code.

(iii) The central issue was whether federal bankruptcy law applied, or the restrictive Arizona LLC law applied. This turned on whether the articles of organization and operating agreement defining the membership interest was an "executory contract" requiring the application of Arizona law under section 365 of the Bankruptcy Code. The flip side was whether the membership interest was a "non-executory contract," and thus simply a property interest under section 541 of the bankruptcy code such that federal bankruptcy law would apply, rather than Arizona law.

(iv) 1. After a very detailed analysis, the court concluded that a membership interest which does not include any management rights or responsibilities and does not require the non-managing member to do anything of substance should not be considered an executory contract. Such a membership interest should be considered part of a non-executory contract, and the membership interest would be subject to section 541 of the Bankruptcy Code, rather than Arizona law.

2. The Court noted that the membership interest might have been considered an executory contract if the member had substantial obligations to perform, and the non-performance of which would have amounted to breach of contract. But the debtor simply had no such obligations under the LLC's operating agreement.

3. The effect of the court's ruling is that the restrictive language of an operating agreement does not control the creditors' rights in bankruptcy if the debtor's interest was non-executory. In other words, the bankruptcy trustee becomes a full member of the LLC even if the operating agreement provides otherwise.

4. The charging order as set forth in Section 703 of the Colorado Limited Liability Company Act, exists to protect **other** members of an LLC from having involuntarily to share governance responsibilities with someone they did not choose, or from having to accept a creditor of another member as a co-manager. A charging order protects the autonomy of the original members, and their ability to manage their own enterprise. In a single-member entity, there are no non-debtor members to protect. The charging order limitation serves no purpose in a single member limited liability company, because there are no other parties' interests affected. *In re Ashley Albright*, 291 B.R. 538, 541 (Bankr. D. Colorado April 4, 2003).

(v) Florida Law specifically provides that a charging order is the sole and exclusive remedy by which a judgment creditor of a member may satisfy a judgment, and, consistent with the partnership rules, expressly provides foreclosure of the debtor's LLC interest as an unavailable remedy to the judgment creditor. Although the new statute does not expressly state the charging order is the exclusive remedy for multimember LLC's, the application of the statute to single member LLC's could be difficult from a practical perspective.

(vi) 605.0503 "*Charging order. –*

(1) On application to a court of competent jurisdiction by a judgment creditor or a member or a transferee, the court may enter a charging order against the transferable interest of the member or transferee for payment of the unsatisfied amount of the judgment with interest. ***Except as provided in subsection (5), a charging order constitutes a lien upon a judgment debtor's transferable interest and requires the limited liability company to pay over to the judgment creditor a distribution that would otherwise be paid to the judgment debtor.***

(2) This chapter does not deprive a member or transferee of the benefit of any exemption law applicable to the transferable interest of the member or transferee.

(3) ***Except as provided in subsections (4) and (5), a charging order is the sole and exclusive remedy by which a judgment creditor of a member or member's transferee may satisfy a judgment from the judgment debtor's interest in a limited liability company or rights to distributions from the limited liability company.***

(4) ***In the case of a limited liability company that has only one member, if a judgment creditor of a member or member's transferee establishes to the satisfaction of a court of competent jurisdiction that distributions under a charging order will not satisfy the judgment with a reasonable time, a charging order is not the sole and exclusive remedy by which the judgment creditor may satisfy the judgment against a judgment debtor who is the sole member of a limited liability company or the transferee of the sole member, and upon such showing, the court may order the sale of that interest in the limited liability company pursuant to a foreclosure sale. A judgment creditor may make a showing to the court that distributions under a charging order will not satisfy the judgment within a reasonable time at any time after the entry of the judgment and may do so at the same time that the judgment creditor applies for the entry of a charging order.***

4. Note Distinction:

(a) Limited Partnerships- F.S. 620.1703(h)(3)
"this section provides the exclusive remedy…other remedies, including foreclosure on the partner's interest…and a court order for directors, accounts and inquires that the debtor general or limited partner might have made, are not available to the judgment creditor attempting to

satisfy the judgment out of the judgment debtor's interest in the limited partnership."

(b) LLC – F. S. 605.0503(8)
"…a charging order is the sole and exclusive remedy by which a judgment creditor of a member… may satisfy a judgment from the judgment debtor's interest in a limited liability company…"

IV. RETAINED INTEREST CONSIDERATIONS

A. Any lifetime transfers of business interests must consider the provisions of IRC § 2036 dealing with retained voting control if the property is to be removed from the donor's estate, *i.e.*, the "fruit of the tree" doctrine.

1. **IRC § 2036(b)** provides that the retention of voting power of stock in a controlled corporation, directly or indirectly, is considered a retained life estate in that stock.

2. A corporation is controlled if, at any time after the transfer and within 3 years of death, the decedent owned or could vote 20% of the total combined voting power of all stock, and the attribution rules of IRC § 318 apply for purposes of the 20% test.

3. Any retention - even if such rights can be exercised only under certain conditions such as default in note payments or only on certain issues such as merger or liquidation - will pull stock back into transferor's estate. Prop. Treas. Reg. § 20.2036-2(c).

4. Indirect retention also triggers inclusion. **IRC § 2036(a)(2)** deals with a donor's retained right, either alone or in conjunction with any other person, to designate the persons who shall possess or enjoy the transferred property or the income therefrom. Such retention would include a right to vote as trustee or co-trustee, as officer of a corporation owning the stock, as trustee of a reciprocal trust, etc.

(a) Indirect retention will exist where there is any agreement with the decedent, express or implied, that the shareholder will vote the stock in a specified way or will not vote the stock.

(b) Indirect retention will also exist where transferor can obtain the power to vote the stock, as where he could appoint himself trustee of a trust holding the stock.

5. These rules do not apply where the transferor could not vote the transferred stock. Thus, if sole shareholder transfers non-voting stock, the rule doesn't apply even though transferor has 100 percent voting control at all times. However, there is a possibility that the transferor retained the right to determine the beneficial enjoyment of the non-voting stock.

6. Same result is reached if voting shares are transferred to son and transferor retains no voting control, directly and indirectly.

B. A gift of property by a shareholder to a "key employee" will result in taxable income to the employee under IRC § 83.

1. But IRC § 83 applies only to the transfers of property in connection with the performance of services.

2. Thus intrafamily gifts should not be covered since the gift is presumably made because of familial relationships, not the performance of services.

3. But what if the donee/family member is also an employee of the business? Which motive for the gift prevails – love or profit?

4. NOTE: a buy-sell agreement which requires the family member/employee to sell that stock back to the company upon the termination of employment may give the IRS a powerful indication of the driving motive.

V. <u>DONATIVE TRANSFERS</u>

A. INTER VIVOS GIFT. The simplest method of transferring interests in closely held businesses to the next generation is by inter vivos gift, and such gifts are extremely efficient from a tax viewpoint:

1. All post-gift income and appreciation escapes the wealth transfer taxes.

2. The gift tax is computed on a tax-exclusive basis; that is, the gift taxes paid are not included in determining the amount of the taxable transfer. The estate tax, on the other hand, is tax-inclusive in that an estate tax is levied on the funds used to pay that tax.

B. ANNUAL EXCLUSION AND UNIFIED CREDIT. The gift tax rules permit significant amount of property to be given away without the imposition of a wealth transfer tax.

1. Each year, property valued at $14,000 can be given without incurring a Federal gift tax. IRC §2503(b). If the donor's spouse is living and agreeable, the split gift provision of the IRC §2513(a), will permit another annual exclusion to be used, and the permissible gift to the donee would be increased to $28,000.

(a) The annual exclusion for gifts of corporate stock is available even if the corporation has paid no dividends and likely never will do so. TAM 9346003.

2. The unified transfer tax credit would permit gifts of up to $5,430,000 (for 2015) to be made without the immediate payment of a gift tax (but with an increase in the ultimate estate tax to be paid at death). IRC §2505.

3. The unlimited marital deduction of IRC §2523 also means that assets can be transferred between spouses to permit the inter vivos use of the unified credit of both of them.

C. REVALUATION OF GIFTS. Although inter vivos gifts are an excellent means of reducing an estate, there are potential problems when the subject matter of the gift is property difficult to value, such as closely held business interests.

1. The general statute of limitations for gift tax returns is 3 years from the due date. IRC §6501 (a). This statute is extended to 6 years if there is a "substantial omission," which is defined as an omission of gifts valued at more than 25% of the gifts reported. IRC §6501(e).

2. IRC §2504(c) provides that, if the statute of limitations has run on a gift tax return, the gifts reported there cannot be revalued for purposes of determining the gift tax due on any subsequent gift tax return.

(a) But, the IRS has ruled that use of the unified transfer tax credit is mandatory for gifts in excess of the annual exclusion, so no gift tax can be paid until the credit is exhausted. Rev. Rul. 79-398, 1979-2 C.B. 338.

(b) And, the Service has also ruled that the statute of limitations on gifts does not run unless a gift tax is paid (other than by application of the credit). §2504(c); Rev. Rul. 84-11, 1984-1 C.B. 201.

(c) Thus gifts shielded by the credit are <u>always</u> subject to revaluation for purposes of determining gift tax on later transfers.

3. Also remember that the estate tax and the gift tax are unified, meaning that, in the computation of the estate tax, both the gifts made and gift tax paid are considered in arriving at the amount due on the estate tax return.

D. PLANNING POSSIBILITIES.

1. The use of donative transfers will be facilitated if the company creates a class of non-voting common stock, commonly referred to as a "recapitalization", thus separating voting control from equity ownership. Such stock would be useful for the following reasons:

(a) The donor may be more agreeable to giving stock since he retains his voting position.

(b) The lack of voting power may reduce the value of the shares, thus permitting more shares to be given each year.

(c) The presence of nonvoting stock will not prohibit the use of the S corporation election should the company desire to use it.

(d) No problems are encountered under IRC §2036(b).

(e) No problems are encountered under IRC §2701.

(f) Use of nonvoting stock reduces the impact of any control premium attached to the voting stock.

2. (a) Use of the annual exclusion may be recommended since it represents an opportunity to move assets between generations without being subject to any one of the wealth transfer taxes – gift tax, estate tax or generation-skipping tax.

(b) However, the annual cost of determining the value of the assets subject to the gift must be considered.

VI. INSTALLMENT SALES OF A BUSINESS INTEREST

A. OUTRIGHT SALE FOR CASH. A direct sale for cash is the simplest way to structure a taxable transaction. The transferor will probably realize a capital gain, but he will have the cash with which to pay the tax. The problem, however, is a practical one - where does the recipient get the cash with which to buy the owner's stock?

B. INSTALLMENT SALE. An installment sale under IRC §453, with the proceeds payable over a period of time and reported under the installment method, would permit the owner of the interest to spread the recognition of his gain over a longer period. It would also give the new owner a longer period in which to make the required payments.

1. The installment method is available in any sale of an interest in a closely-held business where at least one payment is received after the year of sale. IRC §453(b)(1).

2. Its application is automatic unless the taxpayer elects for it not to apply. IRC §453(d).

3. Unless the sale is to a grantor trust (commonly referred to as a "Defective Grantor Trust"), income is recognized in each payment in the proportion that the gross profit bears the total sales price. IRC §453(c).

C. SALE TO A RELATED PARTY. Where an installment sale is to a "related person," however, a resale by that person will have adverse tax consequences.

1. A "related person" is a spouse, child, grandchild, parent, a partnership of which the seller is a partner, a trust or estate of which the seller is a beneficiary, or a corporation owned 50 percent or more by the seller. IRC §§453(f)(1), 318(a).

(a) Note that the term "related person" does not include a brother, sister, niece, nephew or spouse of child or grandchild.

2. If the related person resells the property within two years of its purchase, a portion of the remaining gain on the original sale is triggered to the original seller.

(a) The amount triggered is limited to the amount of consideration received by the second transferor in the year in question.

(b) Any sale of stock back to the issuing corporation, *i.e.*, a redemption, is not a second disposition.

(c) The death of either the original seller or the original buyer terminates the two-year period.

D. HANDLING INSTALLMENT OBLIGATION IN THE ESTATE PLAN. If an installment sale is made, the note or notes received by the seller would be subject to special rules in the event of their disposition.

1. Upon disposition of an installment obligation, the unreported gain is realized to the holder of the note. IRC §453B(a).

(a) A "disposition" includes virtually any permanent transfer, even a gift. *See* Rev. Rul. 55-757, 1955-2 C.B. 557.

(b) An exception is made for transfers to a revocable trust. Rev. Rul. 74-613, 1974-2 C.B. 153.

(c) Statutory exceptions exist for transfers between spouses or incident to divorce, IRC §453B(g), or transfers on account of the death of the holder, IRC §453B(c).

(d) At one time it was a valid estate planning technique to make an inter vivos transfer of such notes in order to generate the capital gains tax, thus reducing the size of the estate subject to the higher estate tax?

2. If an installment obligation is canceled or allowed to become unenforceable, the holder is treated as having constructively received payment in full on the obligation and then having given those proceeds to the obligor. All deferred gain is thus recognized upon cancellation. IRC §453B(a).

3. If an installment obligation is bequeathed or devised to the obligor or canceled by the executor, the decedent's estate must recognize all unreported gain. IRC §453B(f), IRC §691(a)(5); LR 8552007.

(a) Of course, the transfer of such obligations to a person other than the obligor creates no problems. The unrecognized gain represents income in respect of a decedent and is reported on the installment method by the beneficiary. IRC §691(a)(4).

4. Because of these rules, the estate planning advisors of the note holder must deal with these notes in line with the following principles:

(a) The notes will likely be held by the seller until his death, meaning that the purchaser must be prepared to make all of the required payments.

(b) In the disposition of the seller's property, the purchaser can expect to receive no more than his allotted share of the notes, so his payments will continue to the other beneficiaries of the estate.

(c) Some portion of the notes may be canceled in a gift-giving program, but care must be taken. As stated above, cancellation triggers gain to the holder of the obligation. Moreover, the IRS contends that an installment sale is a gift if, at the time of the sale/transfer, the seller intended to forgive the obligations.

5. Since the installment notes constitute IRD, special care must be taken with any marital deduction formula utilized in the seller's estate plan.

(a) The use of IRD to fund a pecuniary clause triggers the income to the estate.

(b) Accordingly, a fractional share or minimum worth pecuniary formula may be a safer in such cases.

(c) As an alternative, the notes could be left directly to the spouse as a specific bequest without triggering IRD.

VII. <u>"SCIN" AND PRIVATE ANNUITY</u>

A. SELF CANCELING INSTALLMENT NOTE ("SCIN"). A variation of the installment sale is to include a provision in the note that extinguishes the obligation upon the death of the named holder of the note. This creates a "self canceling installment note".

1. The value of a SCIN in the holder's estate will be zero, for no further payments will be received.

2. The seller is initially required to compute and report the gain as if all payments due under the note will be paid.

3. If the holder dies before all payments have been made, the unrealized gain will be triggered in the first return of the estate as a cancellation of an installment obligation. IRC §453B(f); *Estate of Frane v. Com'r*, *supra*.

4. The IRS takes the position that a SCIN is really a private annuity if the actuarial life expectancy of the holder is less than the term of the note.

5. If the term of the note ends within the holder's life expectancy, it will be treated as an installment sale. However, the possibility of death effects the valuation of the note and a gift may result unless there is a premium to the seller to compensate for the self-canceling feature.

(a) The premium can be reflected either in the interest rate or in the purchase price.

(b) There is, however, no clear guidance on how to compute an adequate premium.

B. PRIVATE ANNUITY. Another method of making a taxable transfer may be to convey the stock to the recipient in exchange for fixed, monthly annuity payments to the transferor for his lifetime, perhaps continuing to his spouse for her life. This private annuity is conceptually much like an annuity purchased from a commercial insurance carrier, but when purchased with appreciated property, such as stock, from a person not in the business of selling annuities, some tax consequences will be different.

1. There are advantages of the private annuity for both parties.

(a) For the seller, the greatest advantage is in reducing, or at least freezing, the size of his estate. The property used to purchase the annuity is removed from the estate and, if the annuity payments end at his death, the annuity contract will have a value of zero.

(b) If the annuity has a value equal to the stock given for it, there will be no gift tax consequences to the transfer. For methods of valuing an annuity, *see* Rev. Rul. 84-162, 1984-2 C.B. 200.

(c) An income stream will be provided to the seller. That income will be part capital gain and part ordinary income and will be spread over the period of the annuity payments.

(d) For the purchaser, one advantage is that he does not have to pay for the stock in a lump-sum but may spread the payments over a significant period of time.

(e) A further, albeit contingent, advantage for the purchaser is the possibility that the untimely death of the annuitant will terminate the required payments early, reducing the total cost of acquiring the stock.

2. As with all things, however, there are disadvantages to the private annuity.

(a) For the seller/annuitant, the disadvantage is that he will be required to pay income taxes on the capital gain and ordinary income he receives.

(b) Moreover, the promise of payment he has received is unfunded and unsecured, and should remain so if the desired tax consequences are to be achieved.

(c) Valuation of the stock in setting up the annuity will be difficult. The IRS may differ in its valuation and contend that a gift was made.

(d) For the purchaser/obligor, the disadvantage lies in the financial obligation to make the annuity payments which are indefinite in duration, fixed in amount, non-renegotiable, and non-deductible.

3. The payments under a private annuity would be taxed under §72 just like any other annuity, except that a portion of each payment corresponding to the appreciation in the property used to purchase the annuity will be taxed as capital gain.

4. Since the obligor will be treated as having purchased the stock, his basis equals his cost. Cost here means the total amount of the annuity payments actually made. Initially, the basis will be set at the value of the annuity. If the annuitant lives less than expected, the obligor's basis will be adjusted downward to the total of payments actually made. If the annuitant lives longer, the obligor's basis will increase. Rev. Rul. 55-757, 1955-2 C.B. 557.

5. The obligor gets no deduction for any portion of the annuity payment, even the portion representing ordinary income to the annuitant, since it is the acquisition cost of the stock. *Dix v. Comr*, 392 F.2d 313 (1968); *Kaufman's, Inc. v. Com'r*, 28 T.C. 1179 (1967), acq., 1958-1 C.B. 5.

6. A "GRAT," or "Grantor Retained Annuity Trust," is a form of sale for a private annuity.

7. In comparing a sale for a private annuity to an installment sale for a SCIN:

(a) The purchaser/maker of the SCIN may get a deduction for the interest paid under the investment interest rules.

(b) The payments to be made are finite, regardless of the seller's life expectancy.

(c) The obligation of the purchaser can be secured without disrupting the tax consequences.

(d) However, upon the death of the holder of a SCIN, gain will be recognized, whereas that will not be the case if a private annuity is used as the consideration for the sale.

VIII. STOCK REDEMPTION OR SALE TO AN ESOP

A. STOCK REDEMPTION.

1. Unlike a sale to an outside party, a stock redemption will be treated as a dividend to the extent of the company's earnings and profits under §301, unless it comes within one of the exceptions in §302(b) which permit it to be taxed as the sale of a capital asset.

2. There are 3 exceptions to dividend treatment under §302(b) which are possibly applicable to our bootstrap redemption. They are:

   (a) The "not essentially equivalent to a dividend" redemption.

   (b) The "substantially disproportionate" redemption.

   (c) The redemption in "termination of a shareholder's interest" – IRC §302(b)(3).

      (i) Redemption must include all stock owned, directly or constructively, by the selling shareholder.

      (ii) Attribution rules of IRC §318 generally apply (see below), but the application of the family attribution rules can be waived if certain conditions are met:

         1. Selling shareholder must retain no interest in corporation (including as shareholder, officer, director or employee), other than as a creditor.

         2. He must acquire no interest in the corporation in the 10 years following the redemption (except by gift or bequest).

         3. Stock has not been acquired from or transferred to a related person within the prior 10 years in a transaction having as its principal purpose the avoidance of Federal income tax.

B. ATTRIBUTION RULES OF IRC §318. The attribution rules of IRC §318 must be considered in determining stock ownership.

1. Stock ownership is attributed under IRC §318(a) between entities as follows:

   (a) To an individual from his spouse, children, grandchildren and parents. (Note that there is no attribution from a brother, sister, nephew, niece or a spouse of child or grandchild.)

(b) Between a partner and the partnership of which he is a member.

(c) Between a trust or estate and its beneficiaries.

(d) Between a corporation and any greater-than-50% shareholder.

C. SALE TO ESOP. Because of the restrictions imposed on redemptions by IRC §302, a sale to an outside party may be much easier to accomplish. But such a sale could pass the company outside of the family. If the company had an Employee Stock Ownership Plan (ESOP), however, the stock could be sold to the ESOP in a transaction which would not need to qualify as a redemption.

1. An ESOP is a defined contribution retirement plan designed to invest primarily in employer securities.

2. The ESOP is separate from the company so a sale to the ESOP is not a redemption, and the rules for qualification of a redemption as capital gain do not apply.

IX. BUY-OUT AGREEMENTS

A. BUYOUT AGREEMENTS IN GENERAL.

1. A buyout or "buy-sell" agreement is an agreement among the shareholders to purchase and sell a stock interest upon the occurrence of specified future events (death, disability, bankruptcy, etc.) at a predetermined price.

2. While all shareholders are alive and actively involved in the business, a buy-sell agreement effectively preserves control among the existing shareholders by restricting the ability to transfer a stock interest.

3. The agreement therefore must provide other shareholders the right or option to acquire a stock interest that might otherwise be sold or disposed of to outsiders.

4. For example, in the event of a disabling illness, the disabled shareholder can obtain needed cash in exchange for his stock interest, and the corporation can continue to operate without the ongoing involvement of a disabled shareholder's guardian or other fiduciary.

5. In the event of the death of a shareholder, his beneficiaries will be left in better circumstances by having planned for the disposition of his stock interest. The terms of the agreement will be negotiated while the shareholder was alive, actively involved in the corporation and better able to secure a favorable price and terms. With no agreement, it may be impossible to find a buyer, except at a reduced price or on unfavorable terms. Thus, a market will be created for a minority interest in the corporation by which the illiquid interest can be converted

into cash. Most importantly, the estate (or the beneficiaries thereof) will be relieved of continued involvement in the corporation's affairs.

B. TAX CONSIDERATIONS.

1. A "cross-purchase agreement" is an arrangement by which the remaining shareholders purchase the interest of a terminating shareholder; as compared to a "redemption agreement" by which the corporate entity purchases the terminating interest.

2. If the agreement is funded with insurance on the life of the deceased shareholder, receipt of the insurance proceeds by the surviving shareholders who own such policies does not constitute receipt of taxable income. However, the premium payments by the shareholders on the various policies would not be deductible for income tax purposes.

3. A selling shareholder (or the estate of a deceased shareholder) will be selling a capital asset and any gain will be taxed at capital gains rates. However, because of the "step-up" in basis rules at a shareholder's death, the capital gain will be limited to the appreciation over the stepped-up value.

4. Therefore, there will seldom be any taxable gain on a stock interest purchased from a decedent's estate pursuant to a cross purchase agreement. Consequently, the buying shareholders will have a basis in the acquired stock interest equal to the purchase price (as compared to their original cost basis).

C. SUMMARY OF PROPOSED PROVISIONS. In any event, the proposed buy-sell agreement should address the following:

1. Transfer restrictions. The interests can be transferred only in accordance with the terms of the agreement. Therefore, a shareholder would not be able to voluntarily transfer his interest, nor would an interest be transferable by operation of law.

2. Permitted transfers. Notwithstanding the foregoing restrictions, the agreement should provide that certain transfers are permitted, such as to a spouse, descendant or to a trust for their benefit. However, the transferee would accept the transfer subject to the restrictions set forth in the agreement and, at least to that extent, become a party to the agreement.

3. Events triggering buyout. It is contemplated that a buyout would be triggered upon the (a) proposed sale of the interest, (b) death, (c) disability, (d) dissolution of marriage, (e) involuntary transfer such as attachment by a judgment creditor. Each event may require different purchase terms, for example, an option to meet an outsider's offer, cash for the entire interest on death, installment payments or other triggering events.

4. Buyout procedure. The agreement will have to spell out the procedure to be followed upon a buyout event. For example, what kind of notice must be sent to the remaining shareholders, in what form and when; and how much time do the recipients have to respond or to exercise purchase options.

5. Shareholder interests not purchased. If all or any portion of a stock interest remains unpurchased because the remaining shareholders refuse to exercise the purchase option, should the withdrawing or terminating shareholder be allowed to sell all, or only the unsold portion, of the interest to an outsider.

6. Disability. What should be the rights of a shareholder who withdraws from the corporation because he has become disabled. Assuming he is required to sell his stock interest, what would be appropriate terms. What definitions should be used to clearly establish a disability and how long must the shareholder be disabled in order for the buyout to be triggered.

7. Valuation. A valuation of the corporation should be made on an annual basis. However, there should be some alternative or contingent method of valuing the corporation in the event that the annual valuation does not take place prior to the occurrence of a buyout event.

8. Insurance. Who should be responsible for timely payment of all premiums and protecting against an inadvertent lapse of the policies. This may suggest the use of a trustee or escrow agent to administer the arrangement.

9. Other funding mechanisms. Should the corporation establish a sinking fund or arrange a continuing line of credit with a bank to fund a buyout, or that portion of the buyout that is not otherwise funded by insurance.

10. Installment payments. The agreement must address the terms of the promissory note for the deferred portion of the purchase price including, for example, interest rate, the amount of each payment, the frequency of installment payments, and the security, if any. To what extent would these payments be subordinate to other obligations of the corporation and, furthermore, should the note be transferable.

11. Unnecessary insurance policies. If a shareholder is bought out as a result of his disability or other lifetime event, and the other shareholders own life insurance policies on his life, what disposition should be made of the unneeded policies. Should the terminating shareholder be allowed to purchase the policies on his life, and if so, who is entitled to the cash value of the policy, if any.

12. Termination of agreement. The agreement must provide for its termination, such as upon agreement of all parties, dissolution, reorganization, bankruptcy, etc.

This is not a simple transaction; although, unfortunately, a necessary one as part of the recommended business succession plan.

(i) The expected term of the agreement;

(ii) The current fair market value of the property;

(iii) Anticipated changes in that value during the term of the agreement; and

(iv) The adequacy of any consideration given in exchange for the rights granted under the agreement.

(b) The Regulations also provide that a "right or restriction is treated as comparable . . . if the right or restriction is one that could have been obtained in a fair bargain among unrelated parties in the same business dealing with each other at arm's length."

13. The ability of the Internal Revenue Service to ignore the value set under a buy-sell agreement due to the application of IRC §2703 (or prior law, for that matter) presents a difficult problem for the succession plan.

(a) Remember that the agreement will be a binding contract for purposes of state property law. Thus the valuation formula WILL be binding upon the parties regardless of whether that same value is binding upon the Service in the determination of the transfer tax due.

(b) EXAMPLE: Suppose a buy-sell agreement provides that stock will change hands at book value or $200 per share. A decedent leaves his stock to a marital trust established under his will, but the IRS determines that the actual fair market value of the stock is $400 per share. The result is that the stock will be included in the estate at $400 per share, but only $200 per share will be allowed as a marital deduction. Presumably the remaining value ($200 per share) will be allocated to the credit shelter portion of the estate plan, using the decedent's available credit and perhaps causing the payment of considerable tax.

X. VALUATION OF THE FAMILY LIMITED PARTNERSHIP

A. The normal standard for valuing property under the transfer tax system is "fair market value," which is defined as the "price at which the property would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy and sell and both having reasonable knowledge of relevant facts." *See* Treas. Reg. §§ 20.2031-1(b), 25.2512-1. Rev. Rul. 59-60, 1959-1 C.B. 237 is the basic document containing rules for the valuation of business interest for which there is no public market.

1. Revenue Ruling 59-60 provides a detailed analysis of the relative importance of each of the following factors:

(a) The nature of the business and the history of the enterprise from its inception.

(b) The economic outlook in general and the condition and outlook of the specific industry in particular.

(c) The book value of the stock and the financial condition of the business.

(d) The earning capacity of the company.

(e) The dividend-paying capacity.

(f) Whether or not the enterprise had goodwill or other intangible value.

(g) Sales of the stock and the size of the block of stock to be valued.

(h) The market price of stock in corporations engaged in the same or a similar line of business having their stock actively traded in a free and open market, either on an exchange or over-the-counter period.

2. Revenue Ruling 59-60 suggests that the net value of the underlying assets will be of primary importance for investment or real estate holding companies. Rev. Rul. 59-60, §5(b). For operating companies, the prospective earnings and the goodwill value will be of prime importance.

3. Many family limited partnerships also own portfolio investment assets. The valuation of such entities may be a two-part process, with the non-operating investment assets being valued by appraisal, and the value of the operating arm of the business being valued by capitalization of earnings.

4. However, the valuation process remains very much an art form, not a scientific procedure.

B. The courts have consistently recognized that valuation of interests in family limited partnerships must take into account that, because the transfer is of property for which there is a limited market or of property having limited rights, a discount to reflect this circumstance is appropriate.

1. Adjustments generally allowed, include:

(a) Nonmarketability.

(b) Minority, non-controlling interest discount.

(c) Loss of key man discount.

(d) No necessity of aggregating family interests.

(i) Cases generally do not require aggregation.

(ii) Exception: sole reason for transfer.

One case of interest in which the IRS won its argument is *Estate of Elizabeth B. Murphy*, T.C. Memo. 1990-472. In that case, the decedent transferred a minority block of stock just prior to her death. The court determined that the transfer was made solely to avoid a control premium in valuing her majority interest, and refused to allow a minority discount. However, the court did allow a 20% lack of marketability discount.

(e) Swing vote ruling.

Technical Advice Memorandum 9436005 addressed a donor who owned one hundred percent of the stock of a family business and proposed to transfer five percent to the donor's spouse and thirty percent to each of three children. The IRS agreed that each gift should be valued separately, but reduced a claimed 25% minority and lack of marketability discount because each of the 30% blocks carried a swing vote opportunity that required a slight valuation premium. The ruling analogized the transfer to a gift of a deeply discounted 2% block to one of two 49% shareholders. Contrast the fact situation in TAM 9436005 with the fact situation of Rev. Rul. 93-12. In Rev. Rul. 93-12 there were gifts of 20% to each of five children, so three of the separate interests would need to join together to have control. Therefore, in that situation, there would be much less (if any) of a swing vote premium.

C. The opposite side of a discount for a minority interest is to assert the existence of a premium when valuing a controlling interest.

1. The premium is applied to the value (as otherwise determined) of the general partnership interests holding the management power.

2. Strategically, by making the controlling interest as small as possible, so that the control premium is applied to a smaller sum.

D. Because the valuation process is an art and not a science, it is generally desirable to utilized a professional appraiser experienced in this area, at least when the dollars at risk justify the expense.

E. IRC § 6662 levies a penalty if an estate or gift tax return contains a valuation understatement, as that term is defined in the Code.

1. The penalty amount is 20% of the amount of the underpayment of tax, but only if the amount of the underpayment exceeds $5,000. IRC § 6662(a) and (g).

2. A valuation understatement has occurred if the value reported on the return is 50% or less of the amount finally determined to be the correct value. IRC § 6662(g)(1).

3. NOTE that, if the value as initially reported is 25% or less of the value as finally determined, called a gross valuation misstatement, the penalty amount increases to 40% of the underpayment. IRC § 6662(h).

XI. ETHICAL CONSIDERATIONS

A. CONFLICTS OF INTEREST IN REPRESENTING THE FAMILY LIMITED PARTNERSHIP AND ITS PARTNERS

1. An attorney who has represented the family limited partnership from its inception must determine whether it is possible to continue to represent the partnership, the estate of the deceased partner and its separate partners when it is clear that there is a divergence of interest among the partners.

    (a) Each partner may need special counsel.

    (b) The attorney may try to represent the estate, the partnership (with approval of the general partner and perhaps the consent of the limited partners) and the remaining partners. Each of the limited partners needs to understand the potential conflict of negotiating issues involving voting rights, compensation, liquidation rights, retirement plans, redemption issues, etc. They each may desire separate counsel.

2. Each partner is different and has individual considerations.

    (a) Age, health and stage of life.

    (b) Ability to obtain financing to buy out the other partners.

    (c) The tax impact which would result from different ideas.

3. The Rules Regulating The Florida Bar, Rule 4-1.7, provide that a lawyer shall not represent a client if the representation of that client will be directly adverse to the lawyer's responsibilities to another client or to a third person, or by the lawyer's own interest, unless:

    (a) A lawyer reasonably believes the representation will not adversely affect the relationship with the other client; and

    (b) The client consents, after consultation, to have the attorney represent both parties.

4. The Rules and Comments thereto do not automatically preclude representation of clients with conflicting interests, but require a lawyer to determine whether the conflict will materially interfere with the lawyer's "independent professional judgment" and whether the lawyer believes he can undertake the representation. All clients must consent after consultation for the lawyer to proceed.

(a) Have the clients sign a conflict of interest engagement letter if the lawyer does attempt to represent more than one party.

(b) Include a provision in every agreement that the parties sign acknowledging that they understood that there was a conflict of interest and that they wanted the lawyer to represent all of the parties.

B. TAX REPRESENTATION

1. Although the lawyer can advise the parties how to structure a transaction, or a series of transactions, to minimize the combined taxes, he must advise the clients of the conflict and the advantages and appropriateness of obtaining separate counsel.

2. In addition to the ethical considerations which would violate the Rules Regulating The Florida Bar in representing parties who had the conflict, a lawyer who does represent parties in such conflict is certainly susceptible to being named as a defendant in a legal malpractice action for having failed to give adequate representation to one party or the other, or both.