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ESTATE PLANNING FOR OWNERS OF CLOSELY HELD BUSINESSES

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- Goals
  - What is the client hoping to achieve?
  - Are the goals realistic?
  - Will the current structure or operation of the business impact those goals?

- Structural issues of the business to consider
  - Entity type
    - C-corp
      - Most flexible structure, but the least tax efficient
      - Income is taxed at corporate rates and then distributions to the shareholders are taxed again as dividends
    - S-corp
      - S corps elect to pass income, losses, deductions, and credits through to the shareholders who report the flow through of income and losses on their personal tax returns
      - If a conversion occurs from a C-corp, the company must be an S-corp for at least five years prior to a sale to avoid recapture
      - In order for a trust to qualify as a shareholder either:
        - QSST rules and mandatory income; or
        - ESBT rules and maximum trust taxes
    - LLC/partnership
      - Favorable tax structure similar to S-corp
      - Beware of transfer restrictions
      - Beware of negative capital accounts and in advertently creating a realization event when considering lifetime transfers
  - Management and control
    - Professional management or family?
    - Is there a succession plan in place?
    - How is control defined? Issues and risks with each structure.
      - Majority
      - Supermajority
      - Unanimous
      - Voting v. non-voting interests
  - Real estate
    - Should it be owned by the business or another entity?
    - Is there a market rate lease in place?
    - Succession issues?

- Other considerations
  - Transfer restrictions on business interests?
    - How must the estate plan documents be structured
      - Are interests restricted to descendants?
      - Are trusts for a spouse eligible without consent?
  - Business succession plan
    - Should the successor owners and managers be the same? Independent professionals? Family members?
    - Is there/ should there be a Buy-Sell or other shareholder agreement?
      - Establish a method for valuing the business and provide liquidity to family of deceased shareholder and control to surviving business partners
      - Risk of the valuation being disregarded under new IRS regulations
  - "Women Owned Business"
    - Is this certification important to maintain?
    - All beneficiaries **<u>and</u>** all trustees of at least 51% of stock/membership interest would need to be women
    - This could become an issue with trusts that have an open class such as "all descendants"
  - How to address conflicts of interest between family members who might work for the business (and draw a salary) and those that are simply shareholders
  - Qualified Small Business Stock
- Documentation
  - Copies of governing corporate documents
  - Copy of most recent business tax return
  - Copies of most recent fiscal year financials

- Estate Plan
  - Equalization
    - If not all children will be participating in the business equally, should it be allocated only to the children who are involved?
      - Is this required under the estate plan or just permitted?
    - What if the interest is too large? Should sale be forcible? On what terms and conditions? Options here are numerous.
    - Beware the risks of structuring provisions too rigidly
  - Will the business interest be outright or in trust? If the business interests will be held in trust, you should consider the following:
    - Trustee power / specific authorization
      - Hold business interest and not diversify under the Massachusetts Prudent Investor Act. However, you cannot override marital deduction provisions and the ability for spouse to mandate assets be invested in a way that produces greater income

        - Should you include an authorization to appoint trustees individually as officers or directors and for them to be separately compensated (despite any conflict of interest)
        - Authorization to:
            - vote the shares or membership interests
            - Guarantee loans
            - Sell the company
        - All other powers are exercised by the officers or managers who actually need the powers and those are granted as part of the underlying corporate structure but it could be important to authorize the trustees to consent to or facilitate a variety of other actions
    - ESBT savings clause
        - If the election is made, no distributions can be made to any non-resident alien
        - All income from the S-corp would be taxed to the trust regardless of whether or not it were distributed
    - S-corp provision
        - Mandatory income distributions while the trust holds S-corp stock
        - Only one eligible beneficiary of the trust even is the S-corp stock is ultimately sold during the beneficiary's lifetime

- Planning Opportunities
    - Discounted valuation for partial interests
        - Lack of marketability
            - This discount reflects the fact that an owner of a fractional interest cannot easily sell their interest. If you own Apple stock, you can sell the shares easily. If you own 5% of a family business, there are significantly fewer potential buyers and the process will take longer so a discount is appropriate.
            - Usually the discount is in the 10-25% range
        - Lack of control
            - This discount is due to having less than 50% ownership in the company and therefore lacking control.
            - Usually the minority interest discount is in the 10-20% range. The smaller the ownership the less action that you can block and the discount would be at the higher end of the range.
        - Proposed regulations under I.R.C. §2704 would attempt to substantially curtain these discounts
            - They would amend Sec. 25.2701-2 to address what constitutes control of an LLC or other entity or arrangement that is not a corporation, partnership, or limited partnership
            - They would amend Sec. 25.2704-2 to refine the definition of the term "applicable restriction" by eliminating the comparison to the liquidation limitations of state law

        - They would add a new section to address restrictions on the liquidation of interests and the effect of insubstantial interests held by persons who are not members of the family
- Freezing valuation
    - GRAT
        - Trying to catch a spike in appreciation
        - Retained interest for the donor for a series of years equal to initial contribution plus a nominal interest rate set by the IRS
        - In order to succeed, the grantor must survive the entire term
        - All appreciation beyond the annuity payments passes to the donor's beneficiaries free of gift tax
        - For businesses that do not through off substantial cash flow it can be expensive to do because of the need for new valuations every year.
        - One downside or limitation is that GST exemption cannot be applied at the outset, only to the remainder after the GRAT is successful so there is no way to leverage this technique to grandchildren or GST exempt trusts.
    - Sale
        - Allows you to freeze valuation while receiving a return of the current value
        - Can be structured with an IDGT to avoid any recognition event on the asset
        - Outstanding balance on any note at the time of death becomes IRD and does not receive a stepped up basis
        - If there is an outstanding balance on a note the IRS can raise a 2036 issue
        - Unlike a GRAT, the sale can be structured to significantly leverage the amount of GST exempt property
    - Gift
        - Sometimes, simple is best. If you have a favorable valuation, a straightforward gift – either outright or in trust – might make the most sense for the family
    - Beware Chapter 14 of the Code when structuring complex arrangements to try to allow the founders to continue to receive economic benefits from the business while moving appreciation and equity to their beneficiaries
        - Chapter 14 provides a series of special valuation rules designed to limit the ability of taxpayers to transfer appreciating property to family members while still retaining some interest in or control ("estate freezes.")
        - Sections 2701-2704 cover estate freezes and related transactions and imposes an alternative valuation regime under which the value of the interests transferred are disregarded for purposes of valuing what is retained by the transferor.

- How will the taxes be paid?
  - Liquidity – what are the assets available? Either in the business or otherwise available to the family.
  - Life insurance
    - If the shareholders/members own the insurance, funds to pay for insurance would be taxed as distributions
    - Split dollar
    - If the company owns the life insurance the portion received in excess of the premiums could be treated as income to the company that significantly reduces the available liquidity to purchase the holding <u>unless:</u>
      - Before the policy is issued, the company provides written notice and the employee consents in writing to being insured, <u>and</u>
      - The individual was either (i) an employee within the 12 month period before death, or (ii) a director level employee at the time the contract was issued, <u>or</u>
      - The amount was paid to the family or designated beneficiary of the employee
  - Sec. 6166 election
    - The payment of estate tax can be deferred beyond the normal nine month deadline
    - Requirements
      - The decedent must have been a U.S. citizen or resident at death
      - An interest in a closely held business must comprise more than 35 percent of the decedent's adjusted gross estate (which does not take into account deduction for state estate taxes)
      - The estate's personal representative must make the section 6166 election on a Form 706 Federal Estate Tax Return filed in a timely manner
    - Payment period
      - Up to four years with only required interest payments at low interest rates set by the IRS
      - The tax and additional interest must then be paid in ten annual installments
    - Advantages
      - It is helpful when the estate does not have enough liquid assets to pay the estate taxes when they are due without selling assets at a substantial discount
      - The estate receives a special low interest rate on deferred taxes
      - The estate may engage in speculation by investing the amounts that it would have paid in taxes and receiving a greater return on the investment than it pays in interest
      - Profits or cash flow from the business can be used to pay the deferred taxes due
    - Disadvantages
      - It merely defers the tax

        - Sec. 6166 does not apply to any state estate taxes
        - Unless a special tax lien is placed upon the business and its successor owners, the personal representative must be personally liable for the deferred tax
  - Sec. 754 election
    - The purpose of the election is to reconcile a new partner's outside and inside basis in the partnership. This election allows the new partner to receive the benefits of depreciation or amortization that may not have received if the election was not made.
    - The election must be made in a statement that is filed with the partnership's timely filed return (including any extension) for the tax year during which the distribution or transfer occurs

- Questions and comments?