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Let's Make a Deal! Business Succession Planning

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LET'S MAKE A DEAL!
BUSINESS SUCCESSION PLANNING

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Agenda

- Structuring Divergent Management & Economic Interests
- Planning for Discounts
- Liquidity to Pay the Tax
- Financing the Tax

<u>Divergent Management & Economic Interests</u>

Issue: Not all children are involved with the family business

Client wants to treat all children "equally"
Client also wants to give management only to those who work in the business

Possible Solution 1:

- Structure upper-tier management entity (such as an LLC) with voting and non-voting interests having equal economics
- Then give voting interests to children who are involved
- Ideally, voting interests will be given away during life to avoid control premiums at death

Possible Solution 2:

- Create an upper-tier management entity (such as an LLC) and provide managers with "call" options – or rights to buy out others, but at fair market value
- Other children will have to sign on to agreement in order to receive interests in the entity
- Buyouts can take many forms

Planning for Discounts

Issue: Client wants to maintain control, yet avoid adverse tax consequences

- Client may want to maintain control until death
- This creates the possibility that a "control premium" will be applied when valuing the entity for estate tax purposes
- And even if a control premium is not applied, a lack of control discount seems out of the question
- And, worse, this brings into play IRC Sections 2036 and 2038

Possible Solution: Maintaining control is fairly simple for a married couple

- Arrange for the children to get 10% during life
- Then split the other 90% between husband and wife
- When first spouse dies, his or her 45% will go to a marital trust and qualify for the marital deduction
- When second spouse dies, both 45% blocks (the spouse's and the QTIP's) will qualify for a lack of control discount
    - It is crucial that the surviving spouse NOT have a power of appointment over the QTIP

Another Solution: A Section 2701 compliant "freeze"

- Client maintains the preferred – cannot have voting rights that would trigger 2704
- Guaranteed payments will provide liquidity
    - Risk is that earning could be insufficient to cover them
- Common can be gifted

Liquidity to Pay the Tax

Issue: Providing the business owner's estate with the liquidity necessary to pay the tax

- Generally, this can be done via intra-family buyouts, which can take many forms
- Some forms of buy-outs only make sense if done during life
    - SCINs/Private Annuities/Sale to IDGT
- Others can be done pre or post death
    - Installment sales
- Section 303 redemptions (for corporations) can only be done post death

Self-Cancelling Installment Notes ("SCINs")

- Advantages
    - Effectively freezes the value of the interest sold
    - Gross estate includes only payments received, not the note itself
    - Unlike an annuity, the buyer will never pay more than the face amount plus interest (which face amount or interest, however, may be more than the fair market value or going interest rate because the SCIN injects a premium into the calculation)
    - Tax on gain is paid on installment method
- Disadvantages
    - Premium paid for self-cancellation feature could lead to higher gross estate if client survives to full life expectancy
    - Gain realized but not reported by seller is included on estate's income tax return

Private Annuity Sales

- Advantages
    - Effectively freezes the value of the interest sold
    - Gross estate includes only payments received, not the annuity itself
    - Seller will never run out of money, because payments continue until death
    - Payments are income tax free (because all gain is recognized up front)
- Disadvantages
    - All gain is recognized up front (unless sale is to IDGT)
    - If client lives to life expectancy or beyond, payments made by purchasers and gross estate could both be larger than anticipated

Regular Installment Sales

- Advantages
    - Effectively freezes the value of the interest sold
    - Buyer will never pay more than the face amount plus interest
    - Unlike SCIN, there is no fair market value or interest premium
    - Tax on gain is paid on installment method
    - Can be done post-death

- Disadvantages
  - Note is included in the gross estate if not paid off
  - If done pre-death, gain not yet realized or reported by seller is included on estate's income tax return

Financing the Tax

There are three options:

Option 1: Section 6166

- Business must be at least 35% of the estate and heirs must materially participate
- Only the tax attributable to the business can be deferred
- Allows for 5 years of interest only, and 10 years of interest and principal payments
- Interest is charged at 45% of the rate on underpayments

Option 2: Section 6161

- Allows the government to extend the time to pay by 10 years for "reasonable cause" shown
- Interest is charged at 45% of the rate on underpayments

Option 3: Graegin Loans

- Allows the estate to deduct, up front, all interest that will be paid over the life of the loan
- Must demonstrate that borrowing was necessary, and that loan documents prohibit prepayment
- Best if the lender is a third party, but can be utilized with related entities
- Interest will depend on market factors