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Business Succession Planning: Estate Planning Vehicles, Common Issues, Best Practices

TUESDAY, MAY 21, 2019

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Today's faculty features:

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Business Succession Planning: Estate Planning Vehicles, Common Issues, Best Practices

Michael Hawthorne, Mike Whitty, and Jessica Coutré

Tuesday, May 21, 2019, 1:00pm-2:30pm EDT

The statements in these slides and in this presentation are those of the authors, and should not be attributed to either their law firms or their clients.

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Michael Hawthorne is a Member and Chair of the Washington D.C. Corporate Practice at Dickinson Wright. He is nationally recognized in the areas of corporate law, mergers and acquisitions (M&A), and securities law. Michael has extensive experience working on securities matters and helps his clients comply with related laws and regulations.

Michael assists public and private companies to successfully implement corporate structures that allow them to grow their business through capital formation, M&A, and joint venturing with potential business partners. He advises startups and companies preparing for a public or private offering, ensuring these companies are structured properly in all stages of their development. He has represented seed, venture, and private equity investment funds worth more than $6 billion. He also regularly represents private investment firms seeking investment opportunities and companies raising capital. On either side of these transactions, he taps his extensive knowledge of complex securities and financial instruments to discover, document, and close deals that achieve, and frequently exceeds, his client's goals. Michael has handled more than 50 private placements, more than 25 public offerings, and hundreds of M&A deals and has restructured numerous domestic and international companies.

Michael's clients are involved in a wide range of industries, including manufacturing, telecommunications, distribution, natural resources, health care, energy, restaurant, and technology. He represents many family-owned businesses and works collaboratively with their advisors to provide cross-disciplinary approaches that address issues that are unique to these clients, such as succession planning, trusts and estate preparation, and balancing the needs of multiple generations and other family members. Michael is a long-term member of the International Association of Attorneys for Family-Held Enterprises, Inc. (AFHE), and was the President and Chair for AFHE for seven years.

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Michael Whitty ("Mike") is a Partner in the Corporate Practice Group. He concentrates his practice in estate planning, taxation, and estate and trust administration. Mike represents business owners, principals of venture capital and private equity funds, key executives, investors, and other high net worth individuals in planning for the preservation and transfer of their wealth.

Specifically, he advises individuals and fiduciaries in the design and drafting of estate plans, wills, trusts, lifetime gifts, premarital agreements, and other estate planning documents. Mike has extensive experience with various types of trusts, family limited partnerships, corporate recapitalizations, shareholders' and redemption agreements, private annuities, installment sales, intra-trust sales and other transactions, self-canceling installment notes, and net gifts. He also reviews and manages estate and gift tax returns, including complex reporting and valuation issues.

Additionally, Mike consults with executors, administrators, guardians, and trustees in probate and trust administration. He supervises the drafting of estate administration documents and the filing of pleadings, motions, and accountings with probate courts. He also advises clients in connection with litigation involving disputes between trustees and beneficiaries and in contested trust and tax matters, and he has served as an expert witness in such cases.

Mike is a fellow of the American College of Trusts and Estates Counsel (ACTEC), a fellow of the Family Firm Institute (FFI), and the Vice-President and Treasurer of Attorneys for Family-Held Enterprises (AFHE).

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Jessica Coutré is an attorney in the Corporate Practice Group. Jessica concentrates her practice in estate planning, trust and estate administration and controversy, and related gift, estate, and generation-skipping transfer tax issues for high and ultra-high net worth individuals, their families, and their businesses.

Jessica advises clients on the structuring and implementation of advanced estate planning strategies, supplemental needs trusts for disabled loved ones, pre- and post-nuptial agreements, and charitable planning through the creation of private foundations, public charities, and charitable trusts. She works closely with clients to advise them regarding asset protection planning, business succession planning, and fiduciary income and estate and gift tax issues.

Jessica administers taxable and non-taxable decedent's estates and related trusts including the settlement of creditor claims, filing estate tax returns, and preparing trust accountings. When estate and trust matters escalate into controversies, Jessica works to find practical solutions and family reconciliation through the use of nonjudicial settlement agreements and other pre-litigation resolution techniques as well as representing clients in will and trust contest and trust litigation matters.

In recognition for her legal work in the area of trusts and estates, Jessica has been selected as a 2018-2020 fellow for the American Bar Association – Real Property, Trust & Estate Section.

Importance of Succession Planning

- There are few events in the life of a business that are as critical as replacing an owner.
- Without a firm succession plan in place, there is a high risk that the company will fail.
- Replacing an owner is not only stressful on the successor owner, but also the:
  - employees,
  - customers,
  - suppliers, and
  - other stakeholders in the business.

Role of Advisors in Succession Planning

- Advisors can provide valuable guidance and implementation for several essential aspects of succession planning for a private business.
- We will be discussing:
  - corporate governance documents and matters,
  - estate planning vehicles,
  - financial issues, and
  - related subjects.

Benefit to Attendees

- This discussion will help you market to existing clients and prospective clients early on in the process, which will help yield better results for everyone.
- This webinar's panel believes strongly in a **cross-disciplinary** approach in working with clients and developing a plan early on in the process.
  - Cross-Disciplinary (or Multi-Disciplinary), consistent with mission of **Attorneys for Family-Held Enterprises** (AFHE):
    - Corporate/Business Lawyer *and* Estate Planner
    - Tax Planner and/or CPA
    - Succession Consultants

Overview of the Succession Process and Making the Case for Succession Planning

- Our panel will provide counsel in developing and implementing such a process and an appropriate succession plan.
- The panel will discuss how to build a business case and address other needs to help create a successful succession plan and process.

Overview of Topics Discussed

We will review these and other relevant topics:

- Why is succession planning important for all businesses?
- Distinction of Succession Planning from Exit Planning
- What is an estate planner's role in drafting and maintaining a business succession plan?
- What are the common types of corporate governance structures and estate planning vehicles used in succession planning?

Overview of Topics Discussed, continued

- Why is the ***process*** important?
- Which employees should be included in a company's succession plan?
- How to build a ***cross-disciplinary*** collaborative approach to help in the succession plan and its implementation.
- Estate Planning Vehicles Compatible With and Complementary to Succession Planning

Importance of Having a Plan – Even One You Know Will Change

- **The Voyage**: a succession plan is not merely one transaction, it is a *process*, or *voyage*.
- **Survival of Plans**
  - "No plan survives first contact with the enemy." *attributed (in variations) to Helmuth von Moltke*
  - "In preparing for battle, I have always found that plans are useless but planning is indispensable." *attributed (in variations) to Dwight D. Eisenhower*
- **Charting a Course**: Better to chart a course that may need to be corrected later, than to set out adrift without a destination in mind.
- Failure to Plan = **Planning to Fail**?

Succession Planning as a *Process;* Importance of the Process

- Succession planning is a ***process***, not merely a ***step*** or a ***transaction***. The first plan is rarely the last.
- Succession planning is ***dynamic***, it is ***collaborative***, and it requires ***input from multiple stakeholders and advisors*** in addition to the key decision-makers.
- It is true that a bare-bones, stop-gap, ***preliminary*** succession plan can be designed and implemented in a fairly short time without all the input necessary for an optimal, fully-developed plan, and this preliminary plan is ***better than nothing***. If the preliminary plan is all a client currently has the time and money budget for, help them do that while clearly communicating the need to do more.

Identification of Primary Goals and Considerations

- **Identification of Client** (founder vs. company vs. other shareholders vs. founder's family members)
- Succession Plans versus Other Exit Strategies (not mutually exclusive)
- No two situations are exactly alike; different owners will require different succession plans.
  - One form if intent is to **retain** the business for the **long term**
  - Another form of plan if owner **expects to sell** before turning over control or ownership
- Identify where the business owner would like to be — you can't chart a course unless you know the destination.
- Perform triage on all the things you could do, and focus first on those things you **must** do.

Identification of Primary Goals and Considerations, continued

Two principles the owner must understand:

- “Fair” does not necessarily mean “equal”
  when it comes to allocating and distributing interests in the business among family members
  (or among non-family key employees).
- Family employees can rarely do it all.

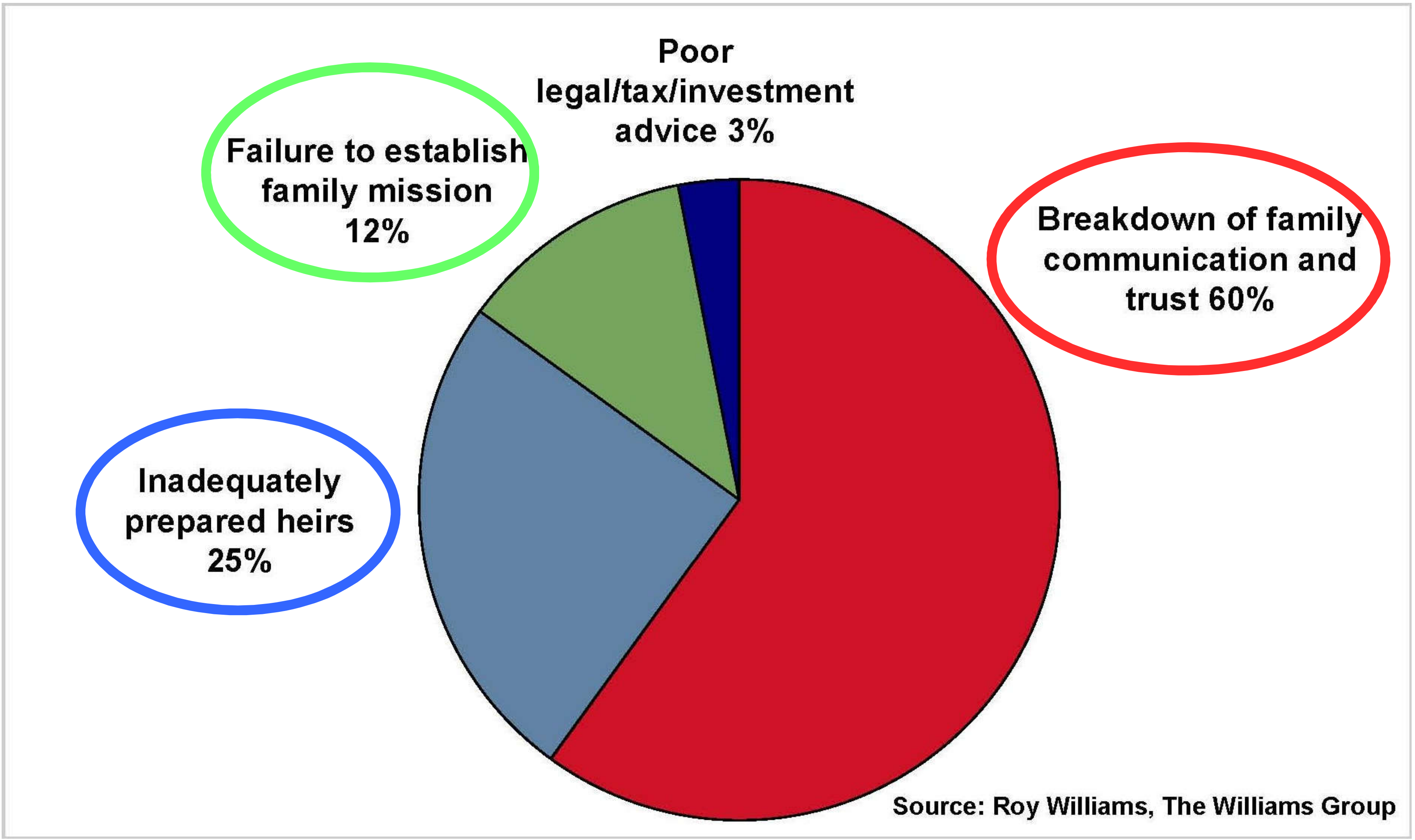
Failure to Make an Estate Plan Consistent With the Succession Plan

"Fair" does not necessarily mean "equal."

"I Can't Tell You How Pleased I was to Learn That Dad Left All of Us Equal Shares . . ."

Danco / Jonovic, "Someday It'll All Be . . . Who's?"

Causes of Wealth Dissipation



Business Considerations

- Needs of the business:
  - **Financial Capital** (cash flow, equity investment, credit and access to more credit),
  - **Human Capital** (talent and expertise)
  - plenty of **Strategy**
  - **Ideas** and **Technology**
- Lenders, equity investors, non-family key executives generally welcome and encourage a succession plan.

Corporate Matters Affecting Succession

- Technology
- Datarooms
- Insurance
- Banking Relationships
- Diversification
- Compliance with Securities Laws
- Insurance:
  - Directors & Officers
  - Errors & Omissions
  - Fraud & Securities Law

Accounting and Financial Reporting Matters Affecting Succession

- Financial Statements: audited, nor non-audited?
  - What does the business currently have?
  - What does the business truly need?
  - Are records accurate and complete?
- Financial Responsibility and Professional Skills
  - Does the company have or need a CFO?
- Operational Skills and Human Capital
  - Who can run the business
  - Does the company have or need a COO?

Income Tax Considerations

- Take income taxes into account.
  - Sometimes, income taxes are merely a cost of doing business.
  - Sometimes, income taxes might be a show-stopper (especially for a very large taxable gain)
- Income taxes are more likely to affect ***how*** you approach a problem, not ***whether*** you decide to approach the problem in the first place.

Income Tax Considerations

Non-exhaustive list of key ***income tax*** provisions affecting succession planning:

- Tax Status of Primary Entity/Entities:
  - C Corporation Taxation (Subchapter C)
  - Partnership Taxation (Subchapter J)
  - S Corporation Taxation (Subchapter S)
- Section 199A, Passthrough Deduction
- Section 303, Post-Mortem Stock Redemption
- Section 409A, Non-Qualified Compensation
- Section 1202, Small Business Stock Exclusion

Cash Flow Considerations

- Cash flow is critical, both for the business and for the business owner.
  - Plans requiring too much cash flow out of the business can put too much strain on the business.
  - Plans that fail to address the departing owner's continuing cash flow needs (especially retirement and financial planning) could ruin the owner or bring the plan to a halt.

Choice of Entity Considerations

- Limited Liability Companies: very flexible; passthrough
- Limited Partnerships: fairly flexible; passthrough
- C Corporations:
  - Low internal tax rate
  - Distributions (dividends) subject to tax
  - Eligible for Section 1202 small business exclusion; tax-free sale of shares is possible
- S Corporations: passthrough; some other tax advantages

Choice of Entity Considerations

- Some entities allow for easier transitions and transfers than others.
- Example: Subchapter S corporations have strict requirements for:
  - number of shareholders,
  - a single class of stock (ignoring voting differences), and
  - type of shareholders: (only US residents* and only certain types of trusts; generally no entities)

    * Nonresidents can now be potential appointees without disqualification

Governance Issues

Governance Structure: Balancing Competing Needs for Decisive Action, Accountability, and Flexibility

- No single arrangement is right for all businesses, all of the time.
  - Formality or informality,
  - Rigid or flexible structure,
  - With or without ample checks and balances, and
  - Decisions by a consensus of key personnel, or by a single decision maker.
  - Control balanced with Ownership
  - Percentage interests, or Units/Shares

Shareholders Agreement

- **Transfer Restrictions** – A major function of shareholders agreements is to restrict transfers, whether by:
  - outright **prohibition** *(may not be enforceable)*,
  - a **right of first refusal** or **right of first offer**,
  - a **call option** held by the company or other owners
  - a **put option** held by a departing owner, or
  - some **combination** thereof.
- Some agreements facilitate transfers to "permitted transferees" (family members, other shareholders, trusts).

Leadership Succession Planning, Including Backup Plans

- Just as a naval ship has a clear chain of command, the business leader should have a backup plan.
- The process is more involved than simply making a designation on paper (although that's a necessary first step).
- The designated successor should become a real understudy to the current business leader.

The Value of a “Fire Drill” or “Dry Run”

- At some point the succession and estate planning for the business owner will be sufficiently developed that a “dry run” would be worthwhile.
    - A “dry run” would involve the business owner, key managers, employees, and advisors, and possibly the owner’s spouse and mature family members.
    - A hypothetical timeline of events involving the business owner’s major disability, death, or both would set up the scenario.
    - The planners and advisors would then walk through how each event in the scenario affects the business and the family, given the current planning and legal structures in place.
    - This rehearsal process may uncover previously unrecognized gaps in the planning, as well as preparing the family and other stakeholders for what to expect.

Business Operation, Succession, and Governance Documents

- Operating Agreement or By-Laws
- Shareholders Agreement
- Mechanism for Resolving Intermediate Deadlocks
- Designation of Successor Managers/Executives
- Alternative Dispute Resolution
- Buy-Sell Agreement (details below)

Business Operation, Succession, and Governance Documents, continued

Buy-Sell Agreement (or Buy-Sell Provisions of a Shareholders Agreement), including:

- To protect against ownership interests going to outsiders, provisions for covering the "Five Ds," events that trigger a buy or sell obligation, spelling out sources of funding and timing of payments for each:
    - **D**eath - redemption, call, or put rights at fair market value (if estate tax issues to be avoided)
    - **D**isability
    - **D**epartures (voluntary and involuntary, including retirement)
    - **D**ivorce
    - **D**ebts/bankruptcy
- Drag-along and Tag-along Rights
- Ultimate Buyout for Resolving Irreconcilable Deadlocks

Funding the Buy/Sell Provisions; Source and Timing of Payments

Liquidity is necessary to purchase shares of a departing owner.

- Buy-Sell Agreement provisions are practically useless without a source for at least partial liquidity available when a contingent buy-sell provision is triggered.
- An all-cash buyout may not be necessary, or desirable. "Seller Financing" (purchase of some or all the departing owner's interest for an **installment note**) may be the best solution for all parties.

Funding the Buy/Sell Provisions; Source and Timing of Payments, continued

- **Death.** For purchases at death, **life insurance** is useful and arrives at the right time, but it's not so useful for other events that can trigger a buy-sell agreement.
  - Available insurance is used for full purchase or at least a down payment, with any balance being seller-financed.
  - For a **redemption** type of buy-sell, the insurance is owned by and payable to the entity that will redeem interests from the estate.
  - For a **cross-purchase** type of buy-sell, consider using a separate trust or LLC to own insurance.
- **Disability**. Traditional **disability insurance** may not go far enough to provide liquidity for a departing disabled owner, but could provide a down payment, with the balance seller-financed.

Funding the Buy/Sell Provisions; Source and Timing of Payments, continued

- **Departures**: If not the full amount, at least a down payment, could be payable with reserve funds set up in (usually non-qualified) deferred compensation; balance is seller-financed.
- **Divorce**: If no buyout of the current owner's divorcing spouse can be negotiated, a transfer to that spouse is an involuntary transaction, and as such the company has neither the motive nor the liquidity to even make a down payment; buyout is 100% seller financed.
- **Debts/Bankruptcy**: When a buy-sell agreement is triggered by a **bankruptcy**, a transfer to a creditor or bankruptcy estate is an involuntary transaction, so buyout is 100% seller financed.
- An alternative or supplemental method to build up cash reserves for eventual buyouts is the **equity sinking fund** (described below).

Trusts or LLC to Own Insurance for Cross-Funded Buy-Sell Agreements

- The advantage of the cross-selling buy-sell approach over the redemption approach is for **income tax basis**.
  - With the **redemption** approach, the entity buys the interest of the departing owner;
    the remaining owners continue to have their original basis in their ownership interest, which has just increased in value after the redemption.
  - With the **cross-sell** approach, the remaining owners (often through a trust or LLC) acquire interests from the departing owner by purchase, with a stepped up basis for the acquired portion.

The "Equity Sinking Fund": Cash for Redemptions (MDW)

- Most of us have heard of a ***debt sinking fund***, where cash that could be put to immediate use to pay down debt early is instead reserved to pay off the debt at maturity.
  - One example of when a debtor would prefer to build up a debt sinking fund, rather than pay down debt, would be when interest rates had risen *after* the debt had been incurred, and the debtor could make a decent return on the cash reserves in the sinking fund while retaining the flexibility of keeping low-interest debt outstanding.
- An ***equity sinking fund*** is a cash reserve built up over time to redeem shareholders, using funds that might otherwise go out in dividends.
  - Another name for an equity sinking fund might be a "**S**trategic **L**iquidity for **U**nification of **S**hare **H**oldings" fund – but "SLUSH Fund" does have some unfortunate connotations.

The "Equity Sinking Fund" continued

- The **equity sinking fund** is a technique used in connection with some buy-sell agreements.
- It is often coupled with a specific program to allow shareholders to "***put***" all or a portion of their shares to the company every few years, or when the company had built up sufficient cash reserves in the equity sinking fund to be able to fully redeem a shareholder, or redeem a substantial portion of shares from multiple shareholders.
- Although not required, the terms of the share redemption program using the equity sinking fund could be set up to favor:
  - complete redemptions over partial redemptions, and
  - those transactions that qualified for favorable tax treatment as redemptions over those that might be characterized as disguised dividends.

The "Equity Sinking Fund" continued

- The shareholders will need to be persuaded of the benefits of the equity sinking fund, and that the fund is a good use of cash that might otherwise go out as current dividends.
- However, with any business expecting a long-term or multi-generational ownership transition, the likelihood of needing to redeem (or cross-purchase) business interests becomes a matter of "not if, but when."
- The sooner an equity sinking fund or similar program is set up, the longer it will have to build up funds to buy out particularly large interests.

Other Options for Liquidity

- Sell of the entire company
- Sale of a minority or majority interest (a "roll-over" transaction)
- Expand
- "Bolt On" Acquisitions
- Debt Financing: relying on banking relationships for debt / EBITDA loans
- Investment Bankers
- Optionality

Spin-Off of Separate Business Lines

- When family owner-managers participate in different severable business lines,
- giving separate business lines to separate family owner-managers (a form of total or partial **horizontal** divestiture) can:
  - provide good incentives, by structuring compensation to the key leaders of each business line to reward success, and
  - reduce (or at least postpone) future conflicts.

Separation of Capital Assets from Operational Assets

- Consider "spinning off" major capital assets:
  - Land
  - Property, plant, equipment
  - Intellectual property

  and distribute those capital assets (or entities set up to hold those assets) to the inactive shareholders

- A form of **vertical divestiture**
  - Does not *eliminate* future conflicts between inactive shareholders and active shareholders, but…
  - ... it should reduce the number, scope, and frequency of conflicts.
- May involve or affect: debt, bank financing, seller financing, secured vs. unsecured

Recommended Preliminary Step:
The **Voting/Non-Voting Recapitalization**

- Implemented ***before*** any transfers for estate planning or succession planning
  - Almost always helpful, as transfers of substantial economic interests can be made without affecting control
  - Rarely hurts
- Transfers of non-voting interests:
  - Do not have the same estate tax considerations, i.e. Section 2036(b)
  - May be eligible for an additional valuation discount

Recommended Preliminary Step:
The **Voting/Non-Voting Recapitalization**

- Typically a **stock dividend** (or LLC unit equivalent) issuing 9 or 19 shares/units of non-voting for each existing share/unit of voting.
- Covenants and contract provisions regarding change of control should reflect the voting/non-voting distinction, as a change in majority equity ownership is not necessarily a change of control.
- In certain circumstances, non-voting stock might have a right to be converted to voting stock

Core Estate Planning Documents: Necessary, but Not Sufficient, for a Business Owner

Usual components of a “Core”
Estate Plan:

- Pour-Over Will
- Revocable Trust
- Durable General Power of Attorney for Property
- Health Care Power of Attorney
- Living Will
- HIPAA Authorization

Core Estate Planning Documents: Necessary, but Not Sufficient, for a Business Owner

Usual components of a "Core" Estate Plan **for a Business Owner**:

- Pour-Over Will
- Revocable Trust **with Special Business Trustee**
- Durable General Power of Attorney for Property
- **Special Power of Attorney for Business**
- Health Care Power of Attorney
- Living Will
- HIPAA Authorization

Common Transfer Techniques

- Once the business owner has decided to pass on the closely-held business to family members, the owner can decide to give some or all away during life or hold it all until death.
- **Initial Observation**: ***Cheaper to Give Than to Bequeath***
  - For various tax reasons:
    - fractional interest valuation discounts,
    - gift tax calculation on a tax-exclusive basis, and
    - the benefits of shifting growth outside the taxable estate,

    it is much cheaper to transfer by lifetime gifts than by bequests at death.
  - To anticipate the business owner's question,
    this can be done without surrendering control!
    (ex., with a voting/non-voting recapitalization)

Give Early, Give Often

- Especially when leverage gifting techniques are used, time can be an advantage.
- If the business is expected to grow (as it should be, if the owner wants to pass it on), then an ***early gift*** can take advantage of lower gift tax valuations.

Estate Tax Considerations, Generally

- Huge increase in lifetime gift and estate tax exemptions from 2001 ($1MM) through 2019 ($11.4MM)
- Portability of the unused estate tax exemption
- Status of Current Legislation:
  - Current exemption of $11.4MM will sunset after 2025, revert to $5MM plus inflation adjustments after 2010
  - Proposals from some candidates to lower the exemption even further, to $3.5MM or less
- Estate tax calculated on what decedent owned, not what beneficiaries receive

Estate Planning Transfers and Techniques That Work Well for Closely Held Businesses and Succession Planning

- Trusts or LLC to Own Insurance for Cross-Funded Buy-Sell Agreements
  (discussed previously)
- Leveraged Transactions
  - Grantor Retained Annuity Trust ("GRAT")
  - Installment Sale to Grantor Trust
  - Mortality Plays: SCINs, Private Annuities
- Preferred / Common Recapitalization
- Opportunity Shifting
- Transfers Using Derivatives

Leveraged Techniques for Transfers of Business Interests

- Grantor Retained Annuity Trusts (“GRATs”)
- Loans and Sales to Grantor Trusts
- Mortality Plays (Private Annuities and SCINs)

Grantor Retained Annuity Trusts ("GRATs")

- Basic concept of a GRAT:
  - donor transfers an asset such as a business interest to a trust,
  - while retaining an offsetting annuity interest, with a net present value ("NPV") equal to (or almost equal to) the value of the transferred asset;
  - the net value transferred is zero, or as close to zero as the donor can accept.
- Allows the donor to shift future *growth* without making a substantial current gift.
- Functionally like a non-recourse loan to donees.

General Explanation of Grantor Retained Annuity Trust and "Zeroed-Out GRAT"

Grantor

Transferred Assets

Annuity Interest (series of payments)

GRAT

Holds **transferred assets** subject to obligation to pay the Annuity:

- Stock
- Real Estate
- Investments
- LLC Interests

Remainder After Annuity

Beneficiaries

"Zeroed-Out GRAT" means:

Present Value of the **Annuity Interest** (calculated using the Section 7520 Rate) =

(Discounted) Value of the **Transferred Assets**,

therefore the **reportable gift is zero**.

"Freeze" Technique

Appreciation above the Section 7520 Rate flows to the designated beneficiaries, and may be distributed at the end of the annuity term either outright or in trust, without any gift taxes.

Important

Grantor must outlive trust term for the GRAT's remaining assets to be completely out of the Grantor's estate for the estate tax calculation.

Benefits of GRAT For Typical Transfer of Interest in Closely-Held Business

For a common fact pattern involving a closely-held business, the GRAT has a lot to offer:

- **Fast implementation**
  - GRAT trust agreement can be turned around in a couple of days from receiving the direction to proceed.
  - When the GRAT trust agreement is executed,
    a separate standby trust will be contemporaneously created and designated to receive the GRAT remainder after Rich's annuity is paid.
  - This GRAT will include a flexible provision (power of appointment) allowing the later substitution of another trust to receive the GRAT remainder.

Benefits of GRAT For Typical Transfer of Interest in Closely-Held Business, continued

- **Valuation Flexibility**
  - No need to obtain appraisal ahead of the transfer, but an appraisal as of the transfer date would be ordered, mostly based on 12/31/2018 values
  - Any adjustment to the value from a gift tax audit would automatically adjust the annuity payments and thus the value of the offsetting annuity interest, so no increase in gift tax
  - GRAT would capture and make a transfer (offset by the annuity with an NPV based on the Section 7520 rate) of:
    - Arbitrage between the gift date valuation and any future valuation event
    - Future growth after valuation event

Benefits of GRAT For Typical Transfer of Interest in Closely-Held Business, continued

- **Beneficiary Flexibility**
  - The Trust Protector or another non-beneficiary can be given a power of appointment over the GRAT remainder (what's left after the final annuity payment back to Rich).
  - The holder of the power can use that power, at any time before the GRAT annuity term expires, to substitute another, newer, more optimal trust created by the grantor for the same beneficiaries as with the standby trust, in place of the original standby trust.
  - That portion of the remainder over which the power holder does not exercise the power of appointment can be designated to go by default to the standby trust created contemporaneously with the GRAT.

Benefits of GRAT For Typical Transfer of Interest in Closely-Held Business, continued

- **Risk Allocation:** **Downside Risk Retained by Donor**
    - If the asset(s) transferred to the GRAT fail to appreciate at a rate faster than the Section 7520 rate used to value the annuity, and especially if they actually *depreciate* over the course of the GRAT term, there won't be a remainder, and the annuity may not be paid in full.
    - However, that outcome isn't any worse than if the donor had not made the transaction at all, other than transaction costs. The donor has not "burned" any estate or gift tax exemption (or at least not a significant amount).
    - The donor is thus retaining the downside investment risk, at least for the GRAT term. This is attractive for the business owner who is optimistic but not certain about future growth of the business.

Limitations and Considerations for GRATs

- **Estate Tax Inclusion**
  - The current Treasury regulations require an inflated amount of the GRAT, well in excess of the remaining unpaid amount of the donor's retained annuity, to be includible in the grantor's estate.
- **GST Tax Planning**
  - The rules for the generation-skipping transfer tax ("GST Tax") prohibit allocation of GST exemption to a trust while it remains includible in the donor's estate.
  - As at least part of a GRAT remains includible in the donor's estate during the GRAT term, GST exemption can't be applied until the end of that term.

Installment Sale to Grantor Trust

- *Sidebar comment from Mike Whitty:*
  A grantor trust is ***NOT*** *a* ***defective*** *trust in any way, shape, or form*, so MDW avoids that term like the plague. MDW prefers the term "completed gift grantor trust."
- Transactions with grantor trusts have no current income tax effect (no gains, no taxable interest).
- The installment sale to a grantor trust can be structured to have no gift component, if the purchasing trust already has sufficient "seed money," but reporting it as a non-gift on a gift tax return gets the statute of limitation running.

Installment Sale to Grantor Trust

- Current best practices include:
  - Make a "**seed money**" gift of at least 10% of the value of the installment sale, preferably with an asset different from the property to be used for the installment sale.
  - Use an installment note with very flexible terms, such as a long maturity date but with no penalty for pre-payment, and allow payment in kind.
  - "Tax distributions" from the entity provide cash flow for paying down the note.

Installment Sale to Grantor Trust

- Advantages of installment sale technique over a GRAT:
  - When properly structured and implemented, only the remaining unpaid note balance is includible in the transferor's estate.
  - Transaction can be made with a GST exempt trust; the "seed money" gift can be covered with GST Tax exemption, and future appreciation is GST exempt.
  - The loan or installment sale nearly always qualifies for a ***lower interest rate*** and more ***"back-loading"*** than is available with a GRAT.
- ***Caveat:*** unlike the GRAT, the loan is *with recourse* so the trust's other assets are liable for the note.

Mortality Plays: SCIN and Private Annuity

Two variations on the installment sale to a grantor trust are:

- **Self-Canceling Installment Note**: In exchange for a higher interest rate or an additional principal amount, the note will disappear if the transferor/ lender dies before the note is paid off.
- **Private Annuity**: An annuity for the life of the transferor, rather than the fixed term of a GRAT; also disappears when the transferor/lender dies.

Either may be implemented on the front end *or* implemented as a refinancing of an “ordinary” installment note.

Self Canceling Installment Notes ("SCINs") in Business Context

- A SCIN is very similar to a technique described above—
  - the installment sale to a grantor trust—
- except that the transaction has a mortality factor:
  - In exchange for a premium interest rate or a premium addition to the note principal,
  - the installment note provides that the obligation disappears (and no further payments of interest or principal are made) upon the death of the selling business owner.

Private Annuities in the Closely-Held Business Context

- Private annuity particularly promising when seller has impaired life expectancy
- Properly structured, private annuity avoids gift tax *and* leaves nothing in the taxable estate
- Standard §7520 actuarial tables may not be used if death is imminent
  - Two safe harbors allowing use of the §7520 tables are:
    - where the seller survives for eighteen months after the sale or
    - where a qualified medical examination concludes that the seller has a better than 50% chance of surviving for a year after the sale

Private Annuity Alternatives for the Married Owner or Co-Owner

- Two-annuity approach
- Blended approach:
  - Owner with impaired health sells for private annuity, while
  - other owner (or spouse) with a normal or better life expectancy could sell for an installment note without a mortality feature

Financial Security Limitations to Private Annuity

- The private annuity may be appropriate for transferring an interest in a closely-held business.
- To avoid immediate, full taxation of the seller's capital gain on the sale:
  - annuity must be unsecured,
  - seller retains no interest in the transferred business interests or their underlying property, and
  - rate or amount of annuity payments cannot be based upon the income or profits from the business interests that are sold in exchange for the annuity.
- Caution, however: a private annuity faces "immortality risk."

Preferred / Common Recapitalization

- A preferred/common recapitalization is a different form of leverage.
- Usual approach is for the senior generation donor to transfer common interests, retaining a fixed preferred interest.
- Must be compliant with Section 2701, including:
  - Preferred interest must have a fixed return
  - Preferred interest must compound if not paid within four years
- Allows most tax attributes to continue to flow through to the preferred shareholders

Opportunity Shifting

- Involves only the transfer of intangible opportunities, and not the transfer of a vested property interest that is subject to the excise taxes on gift and estate transfers.
- Common example: when a company plans to acquire or open a subsidiary.
- Younger generation owners, or trusts for their benefit, could receive the opportunity to obtain (i) a large portion of the equity, or at least (ii) a large portion of the equity growth, in the new subsidiary.

Transfers of Derivative Interests: Private Options, Phantom Stock, Stock Appreciation Rights

- For owners with (i) a higher tolerance for complexity and (ii) a reason for deferring the actual transfer of business interests, a private option contract allows shift of growth without transfer of assets. *(Caveat: Chapter 14)*
- Similarly, if business will otherwise use a phantom stock plan or stock appreciation rights for key employees, owners could receive some of these interests themselves, then use those in estate planning transactions. *(Caveat: §409A)*

Summary

- Succession is a **process**, not a single transaction
- Have a **plan** even if you may need to change it later
- Make **disclosures** to the stakeholders who need to know
- Flexibility / **Optionality** to keep options open
- Coordinate with plans for **raising capital**
- Coordinate with **estate planning**

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Questions
or
Comments?