Business Succession Planning “101” for the Closely-Held Family Business Owner

The Challenge

Most closely-held business owners are aware that putting a “business succession” plan into place is a good idea. The last several years have been an inordinately challenging time for business owners, as companies have had to grapple with difficult economic conditions, quickly changing markets, and increasing domestic and global competition. This has required business owners to spend significant time and energy in tending to the pressing day-to-day needs of their businesses – leaving little time for addressing key strategic issues that are important to the long-term health and survival of their companies.

The Consequences of Failing to Plan

When a business is family-owned, business and personal considerations often are inseparably intertwined. Family businesses may involve the participation of multiple generations of family members, with spouses, siblings, children, nephews, nieces, and even grandchildren, working together or owning a part of the business. The success and failure of these enterprises can have a profound impact on the business owner, family members, and the company.

Consider, for example, the following scenarios:

• A business owner with only a simple will that was put into place many years ago – and the will does not provide specifically for the passing of business holdings.

• A business owner with children who are actively involved in the business – and other children who are not interested in the business at all.

• A business owner in a second marriage – but with adult children from a first marriage that would be good next-generation owners.

• A business owner whose business interests comprise a large majority of the estate – with relatively few liquid assets with which to pay potential estate taxes on death. If taxes are owing, the estate would need sufficient cash to pay estate taxes before the due date.

• A business owner with young adult children who could run the business some day as part of a family legacy – but the children will not be ready for years to take over the business by themselves.

The consequences of failing to plan properly can include, for example: business interests passing to unintended beneficiaries, family squabbles between beneficiaries who control and manage the business versus those who only have an ownership interest, and a forced sale of business interests in order to raise cash to pay for estate taxes.

The Business Succession and Estate Planning Process

Typically, the family business constitutes a significant percentage of a closely-held business owner’s estate. The business succession and estate plan thus should be integrated and coordinated together. As a starting point, the owner will want to begin the process from a “bird’s eye” view, clarifying what his or her goals and objectives are regarding the business, the family, personal finances, and the estate.

1 See generally, Clayton W. Chan, Business Succession Planning and Estate Planning for the Closely Held Business Owner (Thomson Reuters/Aspatore, 2012).
It is helpful to think about the planning process as a five-step cycle:

- **Preparation and fact gathering.** Discuss and decide on preliminary goals and objectives – business-wise and personally. Gather together current estate and business documents, financial statements, and family information.

- **Putting the core estate plan in place.** The core estate plan includes wills, financial powers of attorney, and health care directives. It also may include, where appropriate, revocable and irrevocable trusts. Revocable trusts may be appropriate for incapacity planning or in order to avoid the probate court process. Irrevocable trusts may include trusts set up as part of the business succession plan to hold company stock for the benefit of the younger generation and irrevocable life insurance trusts, that may help (but not be required) to provide liquidity to the estate for the payment of estate taxes. In this connection, life insurance can be a key component to business and personal planning.

- **Putting a “buy-sell” agreement into place.** Buy-sell agreements govern the contemplated transfer of a shareholder’s (or member’s or partner’s) interests in the company. With respect to business succession and estate planning, the buy-sell will establish to whom the owners are permitted to transfer stock (for example, certain family members and trusts) and arrangements for the purchase of the owner’s interest. The arrangements may include, for example, a “redemption” agreement, where the company agrees to purchase a deceased owner’s interest, and/or a “cross purchase” agreement, where the surviving owners agree to purchase a deceased owner’s interest. These arrangements are often funded with life insurance policies on the lives of the owners.

- **Transferring company stock by gift and/or sale.** Stock transfers may be accomplished during lifetime in order to pass business interests to the next generation and to save on gift, estate, and generation-skipping transfer taxes. For example, this may be part of a plan to gift assets in order to take advantage of prevailing federal lifetime gift tax exemption amounts. The gift or sale of business interests may also be part of an “estate freeze” plan to lock in asset valuations in light of expected future appreciation and/or a plan to gradually pass business interests to the next generation over time. Additionally, depending on the type of entity the family business is, the stock or partnership interests may be “recapitalized” and split into voting and non-voting interests, allowing the senior generation to gift or sell only non-voting interests.

- **Updating the plan.** Once the business succession and estate plan is put into place, it is important for the business owner to revisit it regularly – as family, business, or tax law changes may require updates to the plan.

### The Federal Estate Tax System & Possible Planning Steps

#### Transfer taxes

Most business owners are very familiar with income taxes, having to deal with them regularly in a business and individual context. While income tax considerations play important roles in business succession and estate planning, “transfer taxes” also need to be considered – namely, federal gift, estate, and generation-skipping transfer taxes. Broadly speaking, these taxes are applied on a person’s transfer of property. Major changes to the federal transfer tax laws were enacted under the Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010 (“Tax Relief Act”), which contains certain favorable provisions regarding transfer taxes. The Tax Relief Act, however, is scheduled to “sunset” on January 1, 2013, at which time prior law will take effect (unless there is further legislative action).

The federal gift tax is an excise tax imposed on the transfer of property by gift during any calendar year by an individual, whether resident or nonresident, to be paid by the donor. The Tax Relief Act, however, is scheduled to “sunset” on January 1, 2013, at which time prior law will take effect (unless there is further legislative action).

The federal estate tax is an excise tax imposed on the transfer of property by a decedent’s estate to beneficiaries. The Tax Relief Act provides for an exemption amount of $5,120,000 in 2012 – in other words, generally speaking, an individual may make up to $5,120,000 in lifetime gifts free of federal gift taxes under current law. Additionally, there is the continuing availability of the gift tax “annual exclusion,” which is currently $13,000 per year, per donee (exclusive of the gift tax exemption).

The federal estate tax is an excise tax imposed on the transfer of the “taxable estate” of a decedent. The Tax Relief Act provides for an exemption amount of $5,120,000 from estate taxes in 2012. Note, however, that the gift and estate tax exemptions are “unified” under the Tax Relief Act.

The generation-skipping transfer tax, which is also referred to as the “GST tax,” is an excise tax imposed on transfers of property by a

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transferor to “skip persons.” Generally speaking, transfers to skip persons are transfers to individuals who are two or more generations below the transferor – for example, transfers to a grandchild – or transfers to irrevocable trusts in which grandchildren are the only beneficiaries. The Tax Relief Act provides for an exemption amount of $5,120,000 from GST taxes in 2012. Note that the GST tax is imposed in addition to the estate and gift tax.

In addition to federal transfer taxes, it is important to note that Minnesota applies its own estate tax (with a current exemption of $1,000,000). There also may be applicable estate taxes in other states in which a decedent owns property.

One of the significant areas of the Tax Relief Act of which business owners may take advantage prior to the Act’s sunset in 2013 is the currently available lifetime gifting exemption of $5,120,000. The senior generation may want to consider using some or all of its remaining exemption to gift business interests to the junior generation, outright or in trust. Note that the exemption is scheduled to decrease to $1,000,000 upon sunset of the Act (absent legislative action). The amount of the gift and the form of the gift would depend on the business owner’s specific situation and circumstances.

**Estate freeze techniques**

Two popular methods for transferring stock (or partnership or membership interests) in a business succession context are commonly known as the “GRAT” and the “IDGT.” Essentially, the goal of these techniques is to “freeze” the valuation of assets as of the date of transfer to a certain type of trust, so that any appreciation that occurs after the transfer passes estate tax free (as to the transferor). These techniques are especially effective in low-interest rate environments, as we have now. Valuation discounts also may be available to leverage the effectiveness of these techniques.

Specifically, “GRAT” stands for “grantor retained annuity trust.” In a business succession context, the business owner sets up the trust and transfers assets income tax free into the trust for a specified fixed term. A trustee is appointed to administer and manage the trust. Fixed annuity payments are returned by the trust to the grantor (the business owner) during the fixed term. The annuity payments are determined in relation to a required IRS benchmark interest rate (the “Section 7520 rate”). The annuity payments also may be set so that there is no gift considered to have been made by the grantor as to the original transfer of assets to the GRAT (also known as a “zeroed-out GRAT” or “Walton GRAT”). At the end of the term (if the grantor survives), any appreciation remaining in the trust passes estate tax free (as to the grantor) to the beneficiaries of the trust. The GRAT technique is a statutory creation and is acceptable to the IRS. Note that the GRAT is not an effective generation-skipping transfer tax planning vehicle for transferring assets to grandchildren.

The “IDGT” is a sibling technique of the GRAT and it stands for “intentionally defective grantor trust.” The business owner establishes the IDGT trust and funds it with “seed money” (in a gift transaction). A trustee is appointed to administer and manage the trust. The grantor then sells assets to the IDGT in exchange for a promissory note from the IDGT, in an arm’s-length transaction. Since the IDGT is a grantor trust, however, the sale is treated as income tax neutral (hence the name, “intentionally defective”). The note is based on a benchmark interest rate, such as the “Applicable Federal Rate,” which is lower than the GRAT’s required Section 7520 rate. The note also can be structured with interest-only payments and then a balloon payment at the end, thus leaving more to appreciate over the term of the note. At the end of the term, any remaining assets in the IDGT in excess of the payments returned to the grantor on the note pass to the beneficiaries of the trust estate tax free (as to the transferor). IDGTs can be used as a generation-skipping transfer planning vehicle for passing assets to grandchildren. Unlike the GRAT, the IDGT is not a statutory creation and has not been officially accepted yet by the IRS.

**Next steps**

If you are a closely-held family business owner, the last quarter of 2012 may be an opportune time for you to undertake a new or updated business succession and estate plan. If you are interested in pursuing such planning, please contact your attorney at Moss & Barnett.