Chapter 5: Succession Planning

Corrections were made to this workbook through January of 2013. No subsequent modifications were made.

PURPOSE

At its core, succession planning is a process that involves identifying and developing people with the potential to fill key leadership positions in a business. Succession planning increases the availability of experienced and capable employees who are prepared to assume these roles as they become available. Succession planning is more than simply finding a replacement for current generation leaders. It involves a series of steps integrated into estate and business planning in order to produce an effective leadership transition to individuals interested in and capable of taking over the business.

Many business and personal issues must be considered. Ultimately, the succession plan can take one of several forms including sale to a third party, sale to a family member, or a reorganization of the business to facilitate transfer to family members.

Observation. Succession planning combines certain elements of estate planning and business planning. Consequently, aspects of a succession plan are also present in estate and business plans.

COMMON OBJECTIVES

The objectives of succession planning vary, but some of the more common objectives include the following.

- Transferring the business to children or grandchildren
- Providing employment opportunities for the next generation
- Fostering the longevity and success of the business
- Developing a retirement plan for previous owners
- Developing an appropriate estate plan for all parties to a family business
- Minimizing the tax impact of property transfers

Initial Consideration — The Structure of the Business

As noted earlier, elements of estate planning and business planning are present in succession planning. One of those elements involves the **structure of the business.** The structure is important because the business's organizational form may not only assist in making the business more viable economically for the present generation, but it can also help facilitate a transfer of the business to the next generation.

Single or multiple entities may be used, depending on the particular business, the parties involved, and their objectives. Sometimes, successors may work in related businesses, which lets them supplement their income while also gaining experience in the same line of work as the parents' business. Alternatively, the various businesses can be tied together by a rental agreement. Another option is for the various generations to work together in some form of partnership or joint operation or under an arrangement in which labor and capital are shared.

When multiple entities are involved, they are often tied together by a lease. The type of lease governs whether self-employment (SE) tax applies to the lease income and on what IRS form the lease income is reported. Rents from real estate or personal property leased with real estate are not subject to SE tax.[1] However, in a multiple-entity setting involving the lease of farmland by the landowner to an entity in which the owner materially participates, the lease income is subject to SE tax regardless of whether the lease is a material participation lease. This applies outside the U.S. 8th Circuit Court of Appeals, which includes Arkansas, Iowa, Minnesota, Missouri, Nebraska, North Dakota, and South Dakota.[2] In the 8th Circuit, if the rental income under the lease is representative of a fair market rent, there is no SE tax complication. Typically, the operational entity is either established as a general partnership, LLC, C corporation, or S corporation. The landholding entity is typically a partnership, limited partnership, or LLC.

Regardless of the approach utilized, a plan is required for the ultimate retirement of the older generation and the provision of adequate income during retirement. In addition, if the family business involves heirs who are not interested in participating in the management of the parents' business, it is necessary to determine how to treat these heirs in a manner that is "fair" to all parties.

COMPARING ENTITY TYPES

The most familiar and common entity types (other than sole proprietorships) are corporations and partnerships. Besides a C corporation and a general partnership, there are numerous organizational forms that combine corporate and partnership characteristics. Each entity form has its advantages and disadvantages, and these must be weighed against the overall estate planning, business planning, and succession planning objectives.

The following chart lists various entity forms that are available and the relative advantages and disadvantages of each form with respect to the major tax and nontax issues that are likely to arise.[3]

1. IRC §1402(a)(1).
2. See *Mizell v. Comm'r,* TC Memo 1995-571 (Nov. 29, 1995).
3. McEowen, Roger A., *Principles of Agricultural Law*, Release 31, Aug. 2012, §9.12. Reproduced with permission.

Issue	Sole Proprietorship	C Corp.	General/Limited Liability Partnership	Limited Partnership	Limited Liability Company	S Corp.
Nature of entity	Legal person same as the owner	Legal person separate from shareholder-owners	Aggregate of two or more persons	Aggregate of two or more persons	Aggregate of two or more persons	Legal person separate from shareholder-owners
Life of business	Fixed term; ends when owner dies	Perpetual or fixed term or years	Agreed term; terminates at death of partner; LLP must register annually	Agreed term; terminates at death of partner	Agreed term; terminates at death of partner	Perpetual or fixed term or years
Management decision	Sole proprietor	Elected directors and officers selected by directors	Usually agreement of partners	Usually general partner	Usually manager is elected	Elected directors and officers selected by directors
Formation of entity	Very simple	Relatively simple	Relatively complex; LLP must register	Relatively complex	Relatively simple	Relatively simple
Flexibility in capitalization	N/A	Very flexible	Very flexible	Very flexible	Very flexible	Somewhat inflexible
Limited liability	None	Yes	No; LLP partner exempt from co-partner's torts	No for general partner; yes for limited partner	Yes	Yes
Flexibility in conducting business affairs	Inflexible	Flexible	Flexible	Relatively flexible	Relatively flexible	Somewhat inflexible
Flexibility in taxable year	None	Yes	None	None	None	Little
Allocation of income, losses, deductions, and credits	N/A	Somewhat inflexible	Very flexible	Very flexible	Very flexible	Generally inflexible
Tax effects upon liquidation	No double tax	Difficult to avoid double tax	No double tax	No double tax	No double tax	Generally no double tax (§1374)
Tax-free convertibility to another entity	Yes	Some restrictions	Yes	Yes	Yes	Some restrictions

5

Issue	Sole Proprietorship	C Corp.	General/Limited Liability Partnership	Limited Partnership	Limited Liability Company	S Corp.
Line of business	Very flexible	Few restrictions	Flexible; LLP some restrictions	Very flexible	Few restrictions	Few restrictions
SE income from entity	Yes	No	Yes	Yes for general partner; no for limited partner	Usually; see Prop. Reg. §§1.140-2(a)–18	To extent of salary and bonus
Effect of passive loss limitation rules	N/A	Applies at corp. level; generally avoidable for larger corps.	Partners may or may not materially participate	Ltd. partners deemed not to materially participate	Members may or may not materially participate	Shareholders may or may not materially participate
Availability of entity losses to owners	N/A	No	Flow through of losses to owners	Flow through of losses to owners	Flow through of losses to owners	Flow through of losses to owners
Fringe benefits	Limited compared to C corp.	Widest available	Limited compared to C corp.	Limited compared to C corp.	Limited compared to C corp.	Limited compared to C corp.
Estate planning opportunities	Fair	Very good	Good	Very good	Very good	Fair
Accumulated earnings and PHC tax	N/A	§531 and §541 applicable	No	No	No	No
State taxes	Same as individual	Generally uniform and deductible	Generally uniform	Generally uniform	States vary	States vary
Dividend received deduction	N/A	Allowed	Not allowed	Not allowed	Not allowed	Not allowed
Effect of bus. liabilities on owner's basis	Full effect	No effect	Proportionate share	Limited partners share in nonrecourse	Proportionate share	Only shareholder's own loans
AMT	Subject to AMT	Subject to corporate AMT	Preference items flow to each partner	Preference items flow to each partner	Preference items flow to each member	Preference items flow to each shareholder
Accounting method	Cash method	Depends on size and ownership	Generally may use cash method	Generally may use cash method	Generally may use cash method unless farming syndicate	Generally may use cash method

CHOOSING ENTITY FORM — PRIMARY CONSIDERATIONS

Several observations can be made in terms of choosing the most advantageous entity form.

Continuity

Continuity of existence is important because the going concern value is likely to exceed the dissolution value of a viable business. This can enhance the sale value to interested purchasers as compared, for example, to a sole proprietorship that loses the sole proprietor's services at the time of death. The **corporation** is the classic device for assuring the continuity of the business organization's existence.

The simplest structure is the **sole proprietorship.** Its basic disadvantage is that the entire business is identified with the sole proprietor, and vice versa. This can create substantial succession/transition problems, particularly upon the the sole proprietor's death.

Continuity in a **general partnership** can be specified in the partnership agreement. Some states have adopted the Uniform Partnership Act provision for partnership dissociation. Under this provision, a partner can be removed for, among other things, conduct that threatens the future viability of the partnership. Such removal does not cause a termination of the partnership. For example, in *Giles v. Giles Land Co.,*[4] a family farm/ranch partnership sought court action to dissociate a family member from the partnership after he sued for disclosure of additional partnership documents. The trial court held that he should be dissociated because he engaged in conduct that made it unreasonable to carry on partnership business with him as a partner. The evidence showed a mutual lack of trust between the brother and the other nine family members in the partnership and that removing him was in the partnership's best interest. The court determined that the irreparable deterioration of the relationship between the partners was a valid basis for dissociation. The appellate court affirmed. As a result, the family member's interest must be valued and the partnership could continue without him.

In limited partnerships, a limited partner can **assign** their limited partner interest without impacting dissolution.

In an LLC, when any member dies, retires, resigns, is expelled, or files bankruptcy, the LLC is typically dissolved unless the remaining members agree to continue the business. An LLC should maintain books reflecting each member's capital account. Each member's right to withdraw assets upon liquidation of their interest should be documented.

Transferability

In general, it is easier to transfer partnership interests, LLC interests, and corporate interests than it is to transfer individual assets. The ease of transferability of interests can be an important aspect of succession planning. However, when transferring interests in the business, it is often desirable to transfer ownership of the business **along with all the rights and privileges of the transferor.** A typical state LLC statute addresses any requirement to maintain records regarding each member's contributions, rights to withdraw assets, termination of the LLC, and contains various provisions regarding member conduct and operation of the LLC. Typically, several of these statutory provisions are "default" provisions that prevail unless different provisions desired by the members are outlined in an operating agreement.

With a general partnership, an interest in the entity can be transferred. However, the transferee does not receive the privileges of a partner except for the right to receive the portion of partnership profits to which the transferor was entitled in accordance with the partnership agreement. In addition, the transferee's admission into the partnership is subject to the consent of the remaining partners. The same limitation applies in the context of a limited partnership.

---

4. *Giles v. Giles Land Co.,* No. 105,537, 2012 Kan. App. LEXIS 57 (279 P.3d 139).

Often, the transfer of business interests is restricted in some fashion by contractual agreements such as a buy-sell agreement or stock transfer agreement.

> **Note.** Although transferring assets from an individual to that person's single-member LLC is tax-neutral, there can be nontax consequences. Transferring property subject to debt can trigger a due-on-sale clause, which requires the payment of the debt upon any transfer of the property. In addition, for real estate transfers, a new title insurance policy may be required. For residences transferred to a single-member LLC, the LLC interest may no longer be an exempt asset in bankruptcy (a residence is an exempt asset if owned individually) or may disqualify real estate tax exemptions.

Flexibility

With a corporation, there is great flexibility in creating the desired management structure. It is also possible to set forth who is responsible for different activities in an agreement, regardless of the business form.

With a general partnership, flexibility is possible via the partnership agreement.

In a limited partnership, the management of the entity is vested with the general partner(s), with the limited partner(s) having only a financial interest in the venture.

In an LLC, all members can participate actively in the management of the business without becoming personally liable to third parties for business obligations. However, members can delegate their management authority to a particular member or group of members or to a nonmember manager.

Liability

Sole proprietorships and general partnerships are characterized by **unlimited liability.** If an accident or some other event occurs that creates liability, all of a person's business and personal assets are exposed to risk. However, insurance can be obtained that protects against many types of business risks.

> **Note.** An added concern with general partnerships is that the partners are jointly and severally liable **for each other's acts** that are related to the business,[5] and for third-party losses caused by the partnership in breach of trust.[6] Joint and several liability means that all partners must be joined as defendants (joint liability), and the plaintiff may proceed against any one of the defendants and enforce the judgment against that defendant as if the defendant were not a partner (several liability). However, in some states (such as Colorado, Indiana, and Mississippi), the partners are also jointly and severally liable **for all other debts and obligations** of the partnership in addition to those liabilities resulting from each other's acts.

LLCs and corporations have the characteristic of **limited liability.** If a liability-creating event occurs within the business, owners are generally not personally liable. The business is liable, but personal assets outside the business are not at risk. An exception to this rule may apply if the event creating liability is caused by an owner acting outside the scope of the business. In that situation, that owner's personal assets may also be exposed to risks.

5. National Conference of Commissioners on Uniform State Laws, *Uniform Partnership Act* (1997), §13.

6. National Conference of Commissioners on Uniform State Laws, *Uniform Partnership Act* (1997), §14.

Example 1. Shannon forms an LLC for his accounting business. His intent is to shelter his personal assets from any liability created by the LLC. He elects to be taxed as a C corporation. At the end of 2011, the LLC has accounts payable of $45,000. When Shannon decides to abandon the business, he believes he will not have any personal liability for the accounts payable because of the LLC liability shield.

Unfortunately, Shannon finds out he is personally liable because he treated the business checking account as his personal account. He paid all personal bills from the account and did not distinguish his personal matters from the business matters. Consequently, the creditors "pierced the corporate veil" and Shannon is liable for all of the LLC debts.

A single-member LLC provides the owner with liability protection, but it is treated for tax purposes as a sole proprietorship (by default, the LLC is treated as a disregarded entity). Both the LLC and the corporation provide liability protection for the owner(s) from liabilities of the business. Consequently, tax consequences are the major consideration in choosing between the two.

State courts are still resolving the issue of whether a single-member LLC (SMLLC) should provide a business owner with the same degree of liability protection as that provided by a corporation.[7] There are a few cases on this issue and this emerging area of case law has provided some uncertainly with SMLLC liability protection. Some cases suggest that an SMLLC does not provide the business owner with the same degree of protection as a corporation. However, some of these cases involve court interpretation of state LLC statutes that seemed to provide protection for a partnership-type of LLC entity with two or more members, which is not reflective of the wording in similar statutes of other states. In addition, the Florida Supreme Court's ruling in Olmstead led to an amendment of the Florida LLC statute to "correct" the gap in SMLLC liability protection that the ruling created. This amendment was given retroactive effect.[8]

Under some state LLC statutes, a creditor is limited to the remedy of a **charging order.** A charging order prevents the creditor who attaches the LLC's membership interest from obtaining the voting and management rights associated with the interest. Charging orders insulate the business from the personal creditors of the owners, whereas in a C or S corporation a creditor can get ownership of the actual corporate interest. Charging orders have been held inapplicable to a single-member LLC[9] unless state law specifies otherwise. Charging order protection can also be lost in the event of bankruptcy.

Example 2. Tom, Dick, and Harry form an LLC for their construction business. One evening after a trip to his favorite tavern, Tom hits and kills a pedestrian. Tom's liability insurance is not enough to pay the court-ordered settlement. A motion for charging order is filed against Tom's interest in the LLC. This has the effect of creating a temporary lien on Tom's assignable rights in the LLC (i.e., Tom's right to distributions from the entity).

Assuming the LLC has a profit and makes distributions to the members, Tom's share will go to the estate of the deceased. The LLC issues a Schedule K-1 each year, which becomes taxable income to the member. There is a question that often arises in these types of situations as to whether the Schedule K-1 profit is taxable to the member or the deceased's estate. The general consensus is that it is income to the member (Tom). The deceased's estate only has control over the distributions from the LLC, not the asset itself.

Observation. The LLC operating agreement and state law are crucial for charging orders. A creditor can often be put in a difficult position. This is because tax is owed on a member's share of LLC profits, even if they are not distributed. Thus, a creditor can be liable for taxes even though no income has flowed from the LLC to pay the obligation.

---

7. *Olmstead v. Federal Trade Commission,* 44 So. 3d 76 (2010); *In re Ashley Albright,* 291 BR 538 (Bankr. D. Colo. 2003).

8. See F.S. §§608.433(5), (6) and (7), as added and/or amended by Florida HB 253, signed into law May 31, 2011.

9. *In re Albright,* 291 B.R. 538 (D. Colo. 2003); *In re Modanlo,* 412 B.R. 715 (D. Md. 2006); *Olmstead v. Federal Trade Commission,* 44 So. 3d 76 (Fla. Sup. Ct. 2010).

In limited partnerships, the limited partners have limited liability but the general partners have joint and several liability. Having adequate insurance should be considered before relying on the business entity to provide liability protection.

Limited liability partnership (LLP) statutes typically allow partners in professional general partnerships to shield themselves from liability for contractual obligations of the partnership. However, the partners are typically held personally responsible for their own negligence or the negligence of others that they supervise or otherwise control.

Liquidation

C corporations have high liquidation tax costs. When assets are distributed, they are considered as having been sold inside the corporation and are subject to regular corporate income tax rates. Shareholders incur capital gains tax if corporate distributions on the liquidation of stock exceed the shareholder's basis in the stock.

S corporations also have high liquidation tax costs. The advantage that the S corporation has over the C corporation is that there is a single-tier tax. There is no double taxation of the liquidation proceeds.[10]

A major advantage of partnerships and LLCs taxed as partnerships is that the assets, with some planning, can be distributed tax free. If the assets are sold, there is a single tax at the partner level and none at the partnership level. The major cost of liquidating a partnership may be attorney and accountant fees rather than taxes.

> **Note.** Some businesses structured as limited partnerships have a corporation or LLC as the general partner in order to achieve limited liability protection for the general partner.

10. However, IRC §1374 imposes a built-in gain tax on gain from certain property sales that are made in the 10-year period immediately following an S election by a C corporation.

Other Considerations

1. Apart from any tax consequences, a corporation is subject to greater formation expense and more regulation than the noncorporate form of business.
2. The sole proprietorship can provide tax advantages in some situations, such as when the business loses money or when the owner is in a low tax bracket. The tax advantages of a sole proprietorship combined with some of the tax benefits of a corporation can be realized by incorporating and electing S taxation. However, there are certain disadvantages associated with making an S election, particularly if the business has a significant amount of passive income.[11]
3. Multiple-member LLCs are not treated as disregarded entities. They elect treatment as either a corporation or a partnership.
   - **a.** Multiple-member LLCs are usually taxed as partnerships, thereby avoiding double taxation, and they provide liability protection without the need for a general partner. There is no difference in the tax treatment of an LLC and a partnership. Each LLC member is treated as a partner for tax purposes. The LLC files Form 1065, *U.S. Return of Partnership Income,* and issues Schedule K-1, *Partner's Share of Income, Deductions, Credits, etc.,* to each member. In addition, the SE tax status of LLC members is not entirely clear, particularly when the entity has a designated manager as a member.
   - **b.** Electing treatment as a corporation for tax purposes may be a better choice if the entity expects to provide fringe benefits and does not expect to retain substantial assets.
   - **c.** An LLC can elect to be treated as an S corporation if C corporate attributes are desired, other than the ability to provide tax-favored fringe benefits and the favorable (through 2012) tax rate on dividends. In addition, no SE income passes through to S corporation shareholders, although shareholder compensation is subject to social security, Medicare, and FUTA tax. Noncompensation remuneration is not subject to employment taxes.

Note. To qualify as an S corporation, the entity must meet the following conditions.

- Be a domestic corporation (or entity classified as a corporation for federal income tax purposes)
- Have 100 or fewer owners (husband and wife count as one and attribution rules allow for aggregation of ownership by family members)
- Have eligible shareholders who are U.S. citizens or resident alien individuals, estates, certain types of trusts, and tax-exempt entities
- Have a single class of stock
- Make an S election

Note. For additional details on the formation requirements of an S corporation, see 2012 Volume B, Chapter 1: S Corporation.

5

11. If an S corporation has accumulated earnings and profits (e.g., retained earnings from the period when the S corporation was a C corporation) at the close of the tax year and more than 25% of the S corporation's gross receipts constitute passive investment income, a tax is imposed on corporate income for the year on "excess net passive investment income" at the highest corporate tax rate (IRC §1375(a)). No credit (except fuel tax credit) is allowed against this tax. If the 25% threshold is exceeded for three consecutive years, the corporation's S status is terminated (IRC §1362(d)(3)).

ENTITY COMPARISON — TAX-RELATED CONSIDERATIONS

As noted earlier in this chapter, tax considerations play a major role in entity selection. This section describes some of the more important tax considerations that influence the decision to choose one entity form over another.

Why Choose a C Corporation?

The following table compares the tax brackets for C corporations to other entities taxed as individuals.

	Tax Years Beginning in 1993 and Later		Tax Year 2012	
Bracket	Corporate Taxable Income	Rate (in Percent)	Individual Taxable Income (MFJ)	Rate (in Percent)
1	$ 0– 50,000	15	$ 0– 17,400	10
2	50,001– 75,000	25	17,401– 70,700	15
3	75,001– 100,000	34 [a]	70,701–142,700	25
4	100,001– 335,000	39	142,701–217,450	28
5	335,001–10,000,000	34	217,451–388,350	33
6	10,000,001–15,000,000	35	Over 388,350	35
7	15,000,001–18,333,333	38		
8	Over 18,333,333	35		

[a] If corporate taxable income exceeds $100,000, the tax is increased by the lesser of 5% of the excess or $11,750. For corporate taxable income exceeding $15 million, the amount of tax is increased by the lesser of 3% of the excess or $100,000.

Depending on the business income generated, there can be an income tax advantage in operating as a C corporation rather than as a sole proprietorship or pass-through entity.

FICA Tax

In a corporation, only the salaries paid are subject to social security and Medicare taxes. In a partnership or LLC, the total eligible distributions are subject to both FICA tax and income tax at the individual level, even if all net profits are not distributed. For a sole proprietor, the entire Schedule C or F profit is subject to SE tax. The taxpayer is entitled to a deduction for the deemed employer share of the amount on Form 1040. In an S corporation, net profits are not subject to SE tax even if distributed.

> **Note.** The Medicare portion of the FICA tax (1.45%) applies to taxable income without any upper limit. The social security portion of the tax (4.2% in 2012) applies to the first $110,100 of an employee's earnings in 2012. Beginning in 2013, the Medicare tax increases by 0.9% on earned income in excess of $200,000 ($250,000 for joint filers).

The SE tax advantage of the S corporation could create an incentive to set salaries at an artificially low level. In a C corporation, the incentive is the opposite so as to provide a greater corporate-level deduction. A major IRS audit issue involves determining what a reasonable salary is for taxpayers in C and S corporations.[12] In general, reasonable compensation is the amount that would ordinarily be paid for similar services by similar businesses under similar circumstances.[13] Also, some courts in recent years have utilized an "independent investor" test to determine reasonableness of salaries.[14] The basic question under this test is whether an independent investor would agree to the existing compensation arrangement.

---

12. See, e.g., *David E. Watson, P.C. v. U.S.,* 668 F.3d 1008 (8th Cir. 2012), *aff'g* 714 F. Supp. 2d 954 (S.D. Iowa 2010).

13. Treas. Reg. §1.162-7(b)(3).

14. See, e.g., *Menard, Inc. v. Comm'r,* 560 F.3d 620 (7th Cir. 2009).

Dividends and Asset Distributions

For an S corporation, after the payment of a reasonable salary to the owners (which, as noted above, is subject to FICA tax), the remaining profit is not subject to FICA tax. An LLC does not pay dividends, with the result that all income is subject to SE tax unless it is distributed to a nonmanager member.

When assets are distributed, S corporation shareholders have taxable income and receive an income tax basis equal to the current value of the assets. For LLCs that are taxed as partnerships, distributions are tax-free and members receive a carryover basis in the distributed assets, with the following four primary exceptions.

1. A distribution of money or marketable securities causes the member receiving the distribution to recognize gain to the extent the amount distributed exceeds the member's basis in the LLC interest.
2. A distribution of money or property is ordinary income if the member owns unrealized receivables or inventory items that have appreciated in value and the distribution is not proportional to all members.
3. There can be a gain if the distribution is related to a member's contribution of property to the LLC within seven years of the distribution.
4. A distribution in liquidation of a dissociated member's interest in the LLC may cause the member to recognize ordinary income if the member provided personal services and participated in the LLC's management.

There can be a loss on a complete liquidation of an interest in an LLC if the distribution is less than the member's basis in their LLC interest. Also, a distribution to one member of an LLC can cause gain to the other members if the distribution is disproportionate.

Although there is no entity-level tax for an LLC that is taxed as a partnership, basis adjustments may be necessary.

Fringe Benefits

Health insurance results in a 100% income tax deduction if the business is organized as a sole proprietorship, partnership, or S corporation. Partners in a general partnership are regarded as self-employed for tax purposes. Health insurance is deducted against income tax and not against FICA taxes (i.e., it is deducted on Form 1040 rather than on Schedule F or Schedule C).

Note. For C corporations, corporate-paid health insurance is deductible **before** the calculation of either income or FICA taxes.

In general, pass-through entities typically cannot provide owners with tax-favored fringe benefits to the same extent that C corporations can provide them to shareholder-employees.

Note. The rules allowing or denying fringe benefits to pass-through entity owners are stated explicitly only in the context of partners and partnerships. However, under the default classification rules of Treas. Reg. §301.7701-3(b)(1)(i), a domestic eligible entity with two or more members is automatically treated as a partnership unless it elects to be taxed as an association (i.e., as a corporation). In addition, under IRC §1372, 2% shareholder-employees of an S corporation are subject to the rules that apply to partners, and S corporations are treated as partnerships.[15] Thus, the tax consequences of fringe benefits for members of LLCs taxed as partnerships and for 2% shareholder-employees of S corporations are the same as they are for partners.

15. IRC §1372(a) refers to "2% shareholder" and IRC §1372(b) defines the phrase to mean a shareholder who (after applying the constructive ownership rules of IRC §318(a)) owns on any day during the tax year either more than 2% of the outstanding stock of the S corporation or stock possessing more than 2% of the total combined voting power of the S corporation stock.

Fringe Benefits Available to Pass-Through Entities

Working Condition Fringe Benefits. Property or services supplied by an employer to an employee are tax-free working condition fringe benefits if the employee would be entitled to a business expense deduction for the item under IRC §162 or §167 if the employee paid for it.[16] For this purpose, the term "employee" includes partners who perform services for the partnership. Consequently, partners may receive the following working condition fringe benefits tax-free.

- Business-related use of a company auto, if properly substantiated (The personal-use value of the auto must be treated as compensation income.)
- The business-use portion of company paid country club dues, even though the dues are completely nondeductible
- Job-related education expenses paid by the firm
- Job placement assistance[17]
- The use of a cell phone provided to an employee primarily for noncompensatory business reasons[18]

De Minimis Fringe Benefits. For purposes of the tax-free de minimis fringe benefit rules, "employees" include any recipient of a fringe benefit.[19] Consequently, partners are entitled to tax-free meal money or local transportation fare if provided on an occasional basis in connection with overtime work.[20]

Other de minimis fringe benefits include the following.

- Noncash birthday or holiday gifts with a low FMV, occasional theater or sporting event tickets, and fruit, books, or similar property provided under special circumstances (e.g., because of illness, outstanding performance, or family crisis)[21]
- Traditional awards (such as a gold watch) upon retirement after lengthy service[22]

Dependent Care Assistance. Partners are eligible for the IRC §129 dependent care assistance exclusion. The exclusion is for amounts provided under a written plan of the employer and is limited annually to $5,000 ($2,500 for a married person filing separately). However, for a plan to qualify as a dependent care assistance program, no more than 25% of the amounts paid or incurred by the employer for dependent care assistance during the year may be provided for the class of individuals who are shareholders or owners (or their spouses or dependents), each of whom (on any day of the year) owns more than 5% of the stock or of the capital or profit interest in the employer.[23]

Educational Assistance Programs. IRC §127 allows employers to establish educational assistance programs. Employees can receive up to $5,250 per year of graduate- or undergraduate-level educational assistance tax-free, even if the education is not job related. For this purpose, partners who have earned income from their partnerships are considered employees. The partnership is treated as the employer of these partners.[24] However, no more than 5% of the cost of annual benefits may be provided for the class of individuals (and their spouses and dependents), each of whom (on any day of the year) owns more than 5% of the stock or of the capital or profits interest in the employer.[25]

---

16. Treas. Reg. §1.132-5(a)(1)(i).
17. Rev. Rul. 92-69, 1992-2 CB 51.
18. IRS Notice 2011-72, 2011-38 IRB 407.
19. Treas. Reg. §1.132-1(b)(4).
20. Treas. Reg. §1.132-6(d)(2)(i).
21. Treas. Reg. §1.132-6(e).
22. H. Rept. No. 99-426, PL No. 99-514, p. 105.
23. IRC §129(d)(4).
24. IRC §§127(c)(3) and 401(c)(1).
25. IRC §127(b)(3).

Example 3. Susan and Mary are partners in SM Partnership. Both are part-time students working on master's degrees at the local college. They established an educational assistance program available to all employees, thinking that this would allow them to deduct their tuition. In 2011, they paid the following qualified educational expenses.

Employee	Education Expense	Percentage of Benefits
Susan	$ 5,000	40%
Mary	5,000	40%
Jennifer	2,000	16%
Andrew	500	4%
Total	$12,500	100%

Unfortunately, Susan and Mary later found out the money spent for their tuition was taxable to them because each received over 5% of the total payments.

Observation. Presently, the exclusion for employer-provided educational assistance sunsets at the end of 2012. Unless current law is extended, a partner's gross income will include any amounts paid or expenses incurred by the partnership in providing educational assistance to the partner for courses beginning after December 31, 2012, unless those amounts are otherwise excludable or deductible as trade or business expenses or as expenses attributable to the production of income.

Athletic Facilities. Partners (and their spouses and dependents) can take advantage of the exclusion for on-premises athletic facilities.[26]

No-Additional-Cost Services. An exclusion applies to a service provided to an employee if it does not cause the employer to incur any substantial additional costs. Generally, no-additional-cost services are excess capacity services such as airline, bus, or train tickets; hotel rooms; or telephone services provided free or at a reduced price to employees working in those lines of business.

For purposes of no-additional-cost services, partners who perform services for a partnership are treated as employed by the partnership.

Qualified Employee Discounts. An exclusion applies to a price reduction given to an employee on property or services offered to customers in the ordinary course of the line of business in which the employee performs substantial services. Partners who perform services for a partnership are treated as employees for purposes of this fringe benefit.

Transportation Fringes. A partner **cannot** exclude qualified transportation fringes from income. Qualified transportation fringes include up to $240 per month (for 2012) of qualified parking, up to $125 per month for the combined value of transit passes and transportation in a commuter highway vehicle, and up to $20 per month of qualified bicycle commuting reimbursement.

Retirement Plans. The following are qualified retirement plan options (2012 contribution limits).

- **IRAs.** An individual can contribute the lesser of $5,000 or 100% of taxable compensation for the year (the lesser of $6,000 or 100% of taxable compensation for those between the ages of 50 and 70½).
- **SIMPLE plans**. These plans for available to employers with up to 100 employees. The maximum contribution is $11,500 for an employee under age 50. Employees who have attained age 50 can contribute an additional $2,500.
- **Section 401(k) and 403(b) plans.** Employees can contribute a maximum of $17,000. Employees who have attained age 50 can contribute an additional $5,500.

26. IRC §132(j)(4), Treas. Reg. §1.132-1(b)(1).

THE FAMILY TRUST AS AN ENTITY

For more significant businesses (in terms of value), a family trust (an entity to which property is transferred and held by a trustee for the benefit of a third party) may be developed as part of business succession planning in conjunction with a corporation. A family trust is an inter vivos (created during one's lifetime) discretionary trust. Perhaps the primary benefit of a family trust is that it allows the present owner/operator of the business to retain control over daily decisions and delay decisions concerning the distribution of income and capital from the business until some future time. The trust can take the form of a discretionary trust in which the trustee holds the voting shares of the corporation for the benefit of beneficiaries. Such a trust gives the trustee the power to decide on distributions to the beneficiaries and pass control to them at the appropriate time. Additionally, such a trust can be used as a probate avoidance tool and aid in the overall estate planning process.

Note. The obligations imposed on the trustee are defined in the "trust deed." The trustee has a fiduciary duty to act in the best interest of the beneficiaries and to act in accordance with the terms of the trust deed.

Typically, a family trust is used in conjunction with an estate planning concept known as an "estate freeze" in an attempt to put a cap on the value of the family business interests for estate tax purposes and spread income among family members who are in lower tax brackets than the business owner.

VALUATION DISCOUNTING VIA FAMILY LIMITED PARTNERSHIPS

OVERVIEW

Another tool in succession planning is the use of valuation discounts. Discounting is a well-recognized concept by the Tax Court and other federal courts and is commonplace in the context of closely held businesses for lifetime transfers of interests in the business or transfers at death. Discounts from fair market value (FMV) in the range of 30–45% (combined) are common for minority interests and lack of marketability in closely held entities.[27]

Although discounting can apply to interests in corporations, one of the most common entities for discounting is the family limited partnership (FLP). The principal objective of an FLP is to carry on a closely held business in which management and control are important. FLPs have nontax advantages, but a significant tax advantage is the transfer of present value as well as future appreciation with reduced transfer tax.[28] In many family businesses, the parents contribute most of the partnership assets in exchange for general and limited partnership interests. The following factors can result in discounts from the underlying partnership asset value.

- The nature of the partnership interest
- Whether the transfer creates an assignee interest (an interest giving the holder the right to income from the interest, but not ownership of the interest) with the assignee becoming a partner only upon the consent of the other partners
- State law and provisions in the partnership agreement that restrict liquidation and transfer of the partnership interest

Observation. As the use of FLPs has expanded, so has the focus of the IRS on methods to eliminate part or all of the discounts. In general, FLPs have withstood IRS attack and they produce significant transfer tax savings. However, there are numerous traps for the unwary.

27. See *Estate of Watts,* TC Memo 1985-595 (Dec. 9, 1985) (35% discount of 15% partnership interest for non-marketability for federal estate tax purposes); *Peracchio v. Comm'r,* TC Memo 2003-280 (Sep. 25, 2003) (gifts of FLP interests discounted 6% for minority interest and 25% for lack of marketability).

28. See, e.g., *Estate of Kelley v. Comm'r,* TC Memo 2005-235 (Oct. 11, 2005) (FLP interest valued under net asset value method with 35% discount).

In a typical scenario, the parents who own a family business establish an FLP with the interest of the general partnership totaling 10% of the company's value and the limited partnership's interest totaling 90%. Each year, both parents give each child limited partnership shares with a market value not to exceed the gift tax annual exclusion amount. In this way, the parents progressively transfer business ownership to their children consistent with the present interest annual exclusion for gift tax purposes, and they significantly lessen or eliminate estate taxes at death. Even if the limited partners (children) together own 99% of the company, the general partners (parents) retains all control. A general partner is the only partnership interest with unlimited liability.

The IRS has successfully limited or eliminated valuation discounts upon a finding of certain factors, such as formation of an FLP shortly before death when the sole purpose for formation was to avoid estate taxes or depress asset values with nothing of substance changed as a result of the formation. However, although an FLP formed without a business purpose may be ignored for income tax purposes, the lack of a business purpose should not prevent an FLP from being effective for transfer tax purposes, thereby producing valuation discounts if it is formed in accordance with state law and the entity structure is respected.

Note. The legislative history of Chapter 14 (IRC §§2701–2704) indicates that Congress intended ordinary minority and marketability valuation discounts to be respected, even in a family context.[29]

On the valuation issue, of particular concern is IRC § 2703. Under IRC §2703(a)(2), the value of property for transfer tax purposes is determined without regard to any restrictions on the right to use property. However, restrictions on the right to use property are taken into account if they meet each of the following requirements.

- It is a bona fide business arrangement.
- It is not a device to transfer property to family members for less than full consideration.
- It has terms comparable to those in an arm's-length transaction.

Much of the litigation in this area has involved FLPs and various restrictive agreements. Taxpayers have succeeded in situations in which a legitimate business purpose was established, and personal assets were kept out of the entity.

Note. Discounts based on restrictive agreements were allowed prior to enactment of the "freeze" rules that went into effect on October 8, 1990. Currently, it is much harder to achieve discounts via a restrictive agreement such as a buy-sell agreement. To depress the value of transferred interests, a buy-sell agreement must constitute a bona fide business arrangement, not be a device to transfer property to family members for less than full and adequate consideration, and it must have arm's-length terms.

When an interest in a corporation or partnership is transferred to a family member, any applicable restrictions (such as a restriction on liquidating the entity that the transferor and family members can collectively remove) are disregarded in valuing the transferred interest.[30] This applies only if the transferor and family members control the entity immediately before the transfer. In such instances, the regulations provide that an **applicable restriction** is a limitation on the ability to liquidate the entity that is more restrictive than the limitations that would apply under state law in the absence of the restriction. However, under IRC §2704(b)(3), the term "applicable restriction" does not include any restriction imposed by federal or state law.

Observation. It is important to form the entity in a jurisdiction where state law upholds the liquidation and dissolution provisions of the partnership agreement for IRC §2704(b) purposes.

29. See Omnibus Budget Reconciliation Act of 1990, PL No. 101-580, section 11602a; H.R. Conf. Rept. No. 101-964. Also see *Estate of Bongard v. Comm'r,* 124 TC 95 (2005). (For estate tax purposes, there must be a legitimate and significant nontax reason for creating the FLP.)

30. Treas. Reg. §25.2704-2(a).

Although the technical aspects of IRC §§2703 and 2704 are important and must be satisfied, the more basic planning aspects that establish the tax benefits of an FLP must not be overlooked. These include the following.

- The parties must follow all requirements set forth in state law and the partnership agreement in all actions taken related to the partnership.
- The general partner must retain only those rights and powers normally associated with a general partnership interest under state law (no extraordinary powers).
- The partnership must hold only business or investment assets and not assets for the personal use of the general partner.
- The general partner must report all partnership actions to the limited partners.
- The limited partners must act to ensure that the general partners do not exercise broader authorities over partnership affairs than those granted under state law and the partnership agreement.

Example 4. Jack and Jill own 300 acres of prime investment land. The land has a current FMV of $24,700 per acre and is rented to a neighboring farmer for $400 per acre. In an effort to reduce the size of their estate, Jack and Jill form an FLP. The FLP is structured with 570 units, each of which is valued at $13,000 (($24,700 × 300 acres) ÷ 570 units). Jack is the general partner and makes all management decisions. He owns six units of the partnership. Jill is a limited partner and owns 564 units.

After the FLP is formed, Jill gives each of their five children and their spouses one unit of the FLP. Jill has reduced the size of their estate by $130,000 or ((5 × 2) × $13,000).

FAMILY LIMITED PARTNERSHIPS AND THE IRC §2036 PROBLEM

IRC §2036(a)(1) provides that the gross estate includes the value of property previously transferred by the decedent if the decedent retained the possession or enjoyment of, or the right to the income from, the transferred property. IRC §2036(a)(2) includes in the gross estate property previously transferred by the decedent if the decedent retained the right, either alone or in conjunction with any person, to designate the persons who are to possess or enjoy the transferred property or its income. Thus, pursuant to §2036(a)(2), the IRS may assert that because a general partner (or majority shareholder) controls partnership distributions, a transferred partnership interest should be taxed in the transferring partner's estate.

Example 5. Use the same facts from **Example 4,** except Jill continues to give units to the children and their spouses for the next 10 years. Assuming the land has not appreciated in value, the children and their spouses now own 100 units valued at $1.3 million.

Jill dies shortly after the last gift. Her estate reports her portion of the land as 464 units valued at $6.032 million (464 × $13,000). The FLP has never made any distributions of money to the unitholders, with the exception of Jack and Jill. Accordingly, the IRS can increase the size of Jill's estate by $1.3 million (the value of the units gifted) because IRC §2036(a)(1) was violated.

In the typical FLP scenario, the parents establish the FLP with themselves as the general partners and gift the limited partnership interests to their children. In this situation, if the general partners have the discretionary right to determine the amount and timing of the distributions of cash or other assets, rather than the distributions being mandatory under the terms of the partnership agreement, the IRS could argue that the general partners (who have transferred interests to the limited partners) have retained the right to designate the persons who will enjoy the income from the transferred property.

> **Note.** An exception to the rules for inclusion in the gross estate exists for transfers through a bona fide sale for an adequate and full consideration.

> **Observation.** The "purpose clause" in the partnership agreement is critical. The clause can be either a short general statement or it may take an entire page; neither type of clause is necessarily correct or incorrect. The actual reasons for creating the partnership are more important than the wording. However, if the reasons for creating the partnership are explained in great detail, the stated reasons should be consistent with the actual purposes rather than simply a list of possible partnership purposes.

From a succession planning perspective, it may be best for one parent to be the transferor of the limited partnership interests and the other to be the general partner. For example, both parents could make contributions to the partnership in the necessary amounts so that one parent receives a 1% general partnership interest and the other parent receives the 99% limited partnership interest. The parent holding the limited partnership interest then makes gifts of the limited partnership interests to the children (or their trusts). The other parent can retain control of the "family assets" while the parent holding the limited partnership interest is the transferor of the interests. IRC §2036 does not have a provision similar to IRC §672(e), in which the grantor is treated as holding the powers of the grantor's spouse. Thus, if one spouse retains control of the partnership and the other spouse is the transferor of the limited partnership interests, then §2036 should not apply.

EQUITABLE TREATMENT OF HEIRS NOT IN THE BUSINESS

Succession planning with a family business may involve the transfer of a business to heirs who include both experienced business people and other nonbusiness heirs. Often, the family business may be the most valuable family asset and the treatment of each of these two types of heirs is frequently a challenge in a succession plan.

For various reasons, it is usually not a good idea to involve nonbusiness heirs in the day-to-day business operation. For instance, some small businesses do not distribute any dividends or other net earnings, which nonbusiness heirs view as important. Additionally, it is common for those involved in the operational business to make day-to-day decisions that may not match with the objectives of nonbusiness heirs (e.g., whether to purchase more assets or distribute earnings). Similarly, the ownership percentage of the nonbusiness heirs is typically small in comparison to the business heirs and, thus, the voting power of the nonbusiness heirs is limited. There may also be little incentive for the operating entity or the business heirs to spend capital to purchase the interest of the nonbusiness heirs. As a result, the value of the nonbusiness heir's minority interest is subject to a substantial valuation discount.

The typical business strategy involves the nonbusiness heirs receiving the nonbusiness assets by inheritance or gift, becoming the beneficiaries of life insurance policies and retirement plans, or acquiring an interest in assets that can be leased to the operating business.

> **Observation.** It is important for the current owners to understand that the nonbusiness heirs may not receive an equal share in the value of assets in comparison to what the business heirs receive.

If the nonbusiness heir is to receive real estate, it may be worthwhile to consider having the real estate subject to a long-term rental contract. The contract can favor the business heirs or subject the property to purchase options in favor of the business heir. These would be used in case the nonbusiness heir wishes to sell. The real estate can also be placed into a business entity, such as a limited liability company, in which all heirs are co-owners.

> **Note.** It is rarely recommended that the children inherit real estate so that they end up owning it as tenants in common. Joint decision making within a tenants-in-common ownership arrangement is difficult. Each co-owner has a power of partition regardless of the size of the ownership interest. This could force a sale of the property. In addition, there is usually no structured buy-out provision put in place with a tenants-in-common ownership. There may also be questions that arise about who has rights of possession, especially if the situation is adversarial. An adversarial relationship may indeed result because ownership is likely to be with in-laws, nieces, nephews, and cousins.

Example 6. Trevor has a son, Jonas, and a daughter, Barbra. Jonas has worked with Trevor in the business for several years and can manage the business. Barbra is married and lives out of state. She has no experience with managing the business. Trevor wants to treat his children equitably. Because Jonas has worked in the business for five years, Trevor decides that Jonas should receive 3% of the business for each year he worked. Trevor has the following assets at the time of his death. His estate is divided as follows.

Asset	Value	Jonas	Barbra
Cash	$ 6,000	$ 6,000	
Personal effects	5,000	2,500	$ 2,500
Marketable securities	1,000,000	109,500	890,500
Business	1,500,000	1,275,000	
Jonas's work share ($1.5 million × 5 years × 3%)		225,000	
Life insurance	500,000		500,000
Total	$3,011,000	$1,618,000	$1,393,000

TRANSFER STRATEGIES

OVERVIEW

A significant aspect of succession planning for many clients involves, at least in part, the transfer of control of the business over time to the next-generation owners. Often, these clients are interested in strategies that can accomplish their transfer goals at the lowest possible tax cost. Planners commonly suggest the utilization of transfer techniques that combine the lifetime gift exemption and annual gift exclusion with entity structuring that provides for valuation discounts on those gifts as well as the assets that remain in the transferor's estate at death. An important part of this strategy for many clients involves satisfying their goal of transferring ownership of the business but retaining sufficient control over the transferred assets until death. The key for the planner in this situation is to guard against retaining so much control in the transferor's hands that the transferred assets are not excluded from the transferor's estate at death and the gifted interests no longer constitute present interest gifts.

In 2012, a taxpayer's lifetime gift exemption is $5.12 million. In 2013, a taxpayer's lifetime gift exemption is $1 million.

PRESENT INTEREST GIFTING

The present interest annual exclusion is a key component of the federal gift tax.[31] The annual exclusion is currently $13,000 per donee. A donor can make annual gifts of up to $13,000 per donee (in cash or an equivalent amount of property) without triggering gift tax, and without the requirement to file Form 709, *United States Gift (and Generation-Skipping Transfer) Tax Return.*[32] Because the exclusion renews each year and is not limited by the number of potential donees, the exclusion can be a key estate planning tool.

Observation. Used wisely, the exclusion can facilitate the passage of significant value to others (typically family members) pre-death to aid in the succession of a family business or a reduction in the potential size of the donor's taxable estate, or both. However, to qualify for the exclusion, the gift must be a present interest; the exclusion does not apply to future interests.

31. See IRC §2503.

32. Spouses can elect split-gift treatment regardless of which spouse actually owns the gifted property. With such an election, the spouses are treated as owning the property equally, thereby allowing gifts of up to $26,000 per donee. Also, under IRC §2503(e), an unlimited exclusion is allowed for direct payment of certain educational and medical expenses. In effect, such transfers are not deemed to be gifts.

Present Interest Gifts Via Trusts

Some taxpayers have their business interests set up in trusts. This raises a question as to whether present-interest gifting can be facilitated via gifts from a trust. Whether gifts are present interests that qualify for the annual exclusion has been a particular issue in the context of trust gifts that benefit minors. In 1945, the U.S. Supreme Court decided two such cases. In *Fondren v. Comm'r*,[33] and *Comm'r v. Disston,*[34] the donor created a trust that benefitted a minor. In *Fondren,* the trustee had the discretion to distribute principal and income for the minor's support, maintenance, and education. In *Disston,* the trustee had to apply such income "as may be necessary for…education, comfort, and support" to the minor's benefit. In both cases, the Court determined that the minor was not entitled to any "specific and identifiable income stream." Thus, no present interest was involved.

However, if the minor (or any other transferor, for that matter) has a right to demand the trust property via a withdrawal of the gifted property from the trust, that is deemed to be the same as outright ownership. Consequently, the gifted property qualifies the donor for an annual exclusion on a per-donee basis.[35]

Such demand powers are relevant in the context of gifted interests in closely held entities, as illustrated by several recent cases.

- In 2003, the U.S. 7th Circuit Court of Appeals, affirming the Tax Court, ruled that because there were substantial restrictions on transferred interests in an LLC, the donee did **not** have a present beneficial interest in the gifted property.[36] Therefore, the gifts of the LLC interests did not qualify for the annual exclusion.
- The Tax Court applied the same principle to transfers of limited partnership interests.[37] In the process, however, the Tax Court provided a list of the types of restrictions that made the gifts future interests.
- A federal district court ruled similarly on LLC interests.[38]
- In early 2012, the Tax Court held that transferred FLP assets were included in the decedent's gross estate. However, the court also held that the decedent (who was the grantor of an irrevocable life insurance trust) made present interest gifts of premium payments even though the premiums were paid directly from a joint checking account instead of transferring money to the trustees to pay the premiums.[39]
- In mid-2012, the Tax Court held that gifts of interests in an FLP qualified for the present interest annual exclusion because the FLP's publicly traded, dividend-paying stock created the need and the funds for the FLP to make distributions to cover the tax.[40]

USE OF FORMULA CLAUSES FOR GIFTING/TRANSFERRING ASSETS

Formula (defined value) clauses are used by taxpayers to avoid unintended gift, estate, and generation-skipping transfer tax (GSTT) consequences when transferring property. The estate tax version utilizes the clause in a will or trust and involves the decedent leaving a set amount of the estate to the decedent's children (or specific beneficiaries), with the residuary estate passing to a charitable organization.

33. *Fondren v. Comm'r,* 324 U.S. 18 (1945).
34. *Comm'r v. Disston,* 325 U.S. 442 (1945).
35. *Crummey v. Comm'r,* 397 F.2d 82 (9th Cir. 1968).
36. *Hackl v. Comm'r,* 335 F.3d 664 (7th Cir. 2003), *aff'g* 118 TC 279 (2002).
37. *Price v. Comm'r,* TC Memo 2010-2 (Jan. 4, 2010).
38. *Fisher v. U.S.,* 105 A.F.T.R. 2010-1347 (S.D. Ind. 2010).
39. *Estate of Turner et al. v. Comm'r,* 138 TC 14 (Mar. 29, 2012), on reconsideration from TC Memo 2011-209 (Aug. 30, 2011). The IRS has not conceded the issue, and it remains important to properly contribute premium amounts to the trust and give notice of withdrawal rights to the beneficiaries.
40. *Estate of Wimmer v. Comm'r,* TC Memo 2012-157 (Jun. 4, 2012).

An alternative technique is for the estate to leave everything to a specific beneficiary, with that beneficiary having the power to disclaim property. The disclaimed property then passes to a charity. The portion passing to the charity qualifies for the estate tax charitable deduction and, thus, limits the amount of estate tax owed. The technique can be very beneficial in minimizing tax on the transfer of assets from one generation to the next when family business assets that are difficult to value are involved.

Observation. This could be a particularly useful concept (especially for farm and ranch estates) if present attempts to eliminate valuation discounts for closely held business interests or to increase the federal estate tax are successful.

The gift tax version of a formula clause works in a similar way by specifying via formula an amount of gifted property to be transferred to family members (or specified nonfamily beneficiaries), with the balance passing to charity. Formula clauses come in two general types: a **definition clause** defines a transfer by reference to the value of a possibly larger, identified property interest; and a **savings clause** retroactively adjusts the value of a transfer due to a subsequent valuation determination.

Observation. Another benefit of the use of a formula clause is that it can prevent the IRS from increasing estate or gift taxes by denying or diminishing valuation discounts. If the IRS succeeds in reducing a claimed valuation discount, the enhanced value either passes to a charity (estate tax formula clause) or is transferred to a charity (gift tax formula clause). The result is an enhanced charitable deduction on either Form 706 or Form 709, with no resulting increase in tax.

Several recent cases have validated the use of formula clauses in the context of succession planning.

- In *Estate of Christiansen v. Comm'r*,[41] the U.S. 8th Circuit Court of Appeals affirmed the Tax Court in rejecting the IRS's position of refusing to recognize "defined value" types of formula clauses. In the case, a sole beneficiary of a South Dakota family ranching operation disclaimed all of the estate (under a fractional formula) in excess of $6.35 million. Seventy-five percent of the disclaimed assets passed to a charitable lead annuity trust (CLAT) and 25% passed to a foundation. The IRS and the estate agreed to increase the value of the gross estate from $6.5 to $9.6 million by virtue of a reduction in the claimed valuation discount in the deceased mother's estate.[42] For the 25% passing to the charity, the IRS asserted two reasons that a charitable deduction should not be permitted for the increased value. First, any increased amount passing to the charity was contingent on future events. Secondly, the final determination depended on the IRS's valuation of the transfer.[43] In addition, the IRS claimed that the transfer violated public policy because it diminished the incentive of the IRS to audit estate tax returns. The Tax Court and the 8th Circuit rejected both arguments.

Observation. The case is a significant taxpayer victory validating the use of defined-value transfers in which the transfer is made and allocated between a taxable and nontaxable portion based on gift or estate tax values in an agreement. The case is also important for transfers whereby the amount transferred is defined by a formula referring to gift or estate tax values. A value "enhancement" by the IRS (typically by denying or reducing a claimed valuation discount) works the same way that a standard marital deduction formula clause works in a will or trust. Under such a clause, an increased value allocates a larger value to the surviving spouse but does not generate additional estate tax. Until the *Christiansen* decision,[44] it was not certain whether courts would uphold inter vivos defined-value transfers against a public policy attack (even though standard marital deduction formula clauses in wills have operated in that same manner for decades).

41. *Estate of Christiansen v. Comm'r,* 586 F.3d 1061 (8th Cir. 2009).

42. The Tax Court held that the disclaimer for the 75% that passed to the CLAT did not satisfy all the technical disclaimer requirements (thus, the estate owed estate tax on that portion of the increased value of the estate). The estate did not appeal that aspect of the case.

43. The IRS position was based on Rev. Rul. 86-41, 1986-1 CB 300.

44. *Estate of Christiansen v. Comm'r,* 586 F.3d 1061 (8th Cir. 2009).

- In *Petter v. Comm'r*,[45] the petitioner inherited several million dollars of UPS stock at the time it was a closely held company. The stock later doubled in value when UPS became publicly traded. Utilizing a part-gift, part-sale transaction, the petitioner transferred her interests in an LLC to intentionally defective trusts. Under an agreement, a block of units in the LLC was first allocated to grantor trusts consistent with the gift tax exclusion, with the balance allocated to charities. The value of the LLC interests was allocated based on their appraised value, but the IRS claimed that the discount should be less and did not respect the formula allocation provisions for gift tax purposes. The court held that the formula allocation provision did not violate public policy. As a result, the gift tax charitable deduction was allowed for the full value passing to charity based on the value as finally determined by the IRS.
- In *Hendrix v. Comm'r*,[46] the taxpayer made a small gift to a charitable donee. The gift was in the form of a fixed-dollar amount of stock that was transferred to family trusts, with the excess passing to the charity. The transfers to trust were structured as part-gift, part-sale transactions. Only the excess of the aggregate amount of the defined transfers to the trusts less the consideration that the trusts paid was treated as a gift. The IRS objected on the basis that the defined-value formula clause was not bona fide because it was not an arm's length transaction. The Tax Court, however, disagreed. The court noted that the transfers to the trusts caused the trusts to incur economic and business risk. That was the case because, if the value of the stock as initially computed was undervalued, more shares would shift from the trusts to the charity.
- In *Wandry v. Comm'r*,[47] the taxpayer prevailed in the utilization of a defined-value clause that was used to determine the FMV of gifts for gift tax purposes. The formula referenced a fixed-dollar amount rather than a transfer of a fixed quantity of property. The taxpayers, a married couple, transferred interests in their family LLC to their four children (worth $261,000 to each child) and five grandchildren (in the amount of $11,000 to each grandchild). **No residual beneficiary was specified in the event that the IRS issued a redetermination of value.** However, the transfer document specified that if a subsequent IRS valuation determination (or a court decision) changed the value of the gifted membership units, the number of the gifted LLC units would be adjusted such that the same value as initially specified would be transferred to each child and grandchild. The IRS challenged the use of the defined-value clause to transfer fixed-dollar amounts of LLC interests to the transferees. The Tax Court ruled that there is no public policy against formula clauses that simply define the rights transferred without undoing prior transfers (as opposed to a "savings clause").

5

45. *Petter v. Comm'r*, TC Memo 2009-280 (Dec. 7, 2009), *aff'd* 653 F.3d 1012 (9th Cir. 2011).

46. *Hendrix v. Comm'r*, TC Memo 2011-133 (Jun. 15, 2011).

47. *Wandry v. Comm'r*, TC Memo 2012-88 (Mar. 26, 2012), appealed to 10th Cir. (Aug. 28, 2012).

INSTALLMENT SALE OF BUSINESS ASSETS[48]

When planning for the sale of a business, it is important to determine the owner's personal goals. Often, a primary consideration is whether the proceeds from the sale of the business will be used to provide security for the owner and the owner's family. One common technique used for the sale of many small businesses and farms, particularly when the business is being transitioned to family members, is the installment sale.

Installment Reporting of Gain

In general, gain or loss must be recognized at the time of sale. However, under the installment method, a seller can defer tax and recognize gain for any particular tax year in proportion to the amount of installments received.[49] This allows the seller to spread the income tax liability over the entire term of the contract. Installment contracts are also beneficial because the periodic payments can be available to the seller for retirement income, a security interest may be retained in the property, and the buyer has control and beneficial enjoyment of the property.

> **Observation.** Inflation can cause financial issues for recipients of fixed principal obligations. Also, the seller may outlive the term of the contract, which can result in income problems if the payments were used for living expenses.

Installment reporting of gain is automatic for eligible property.[50] An election not to have installment reporting apply must be made on or before the due date (including extensions) for filing the income tax return for the year in which the sale occurs.[51] Once an election is made, it can only be revoked with the consent of the IRS. In addition, installment reporting only applies to gain and not to loss on the sale of real property.

Example 7. Charles, age 67, is an architect and is the sole shareholder of CBT Structural Design, Inc. (CBT). Charles has two daughters, Cynthia and Charlene, who are also licensed architects involved in the business. Charles is considering retirement and would like to pass CBT to Cynthia and Charlene. However, the FMV of the business is $1 million and Cynthia and Charlene do not have this amount readily available for the purchase of the business. The daughters also do not wish to borrow this much from a bank to purchase the business from Charles, who needs to receive the FMV of the business to facilitate a comfortable retirement. Charles' basis in the business is $200,000 and there will be a significant capital gain if the business is sold for a lump sum. Charles decides to sell CBT stock under a cross-purchase agreement to Cynthia and Charlene using a 10-year installment sale. This provides the following advantages.

- Charles can spread out the substantial capital gain over the 10 years of the installment sale agreement, which may substantially reduce the overall amount of capital gains tax he will pay on the sale of the business.
- Cynthia and Charlene do not need a lump sum to buy the business but rather can pay Charles gradually using earnings from the business.
- Charles can maintain a security interest on the shares until the end of the installment agreement.
- The installment sale payments made to Charles can be structured annually or even monthly to provide Charles with a flow of periodic retirement income.
- Part of the amount Charles receives within each tax year is a nontaxable return of his basis.
- CBT is not required to record the redemption liability on its balance sheet for accounting purposes.

48. This material is adapted from McEowen, Roger A., *Principles of Agricultural Law*, pp. 9-59–9-60 (Release 31, Aug. 2012), §7.05 [3].

49. IRC §453.

50. IRC §453(d)(1).

51. IRC §453(d)(2).

When real property is sold on an installment basis, part of each payment received represents gain and part represents a nontaxable return of the taxpayer's basis in the property. The amount of the principal payment reported as income for any year is determined by the "gross profit percentage," which is based on the gross profit on the entire transaction and the total contract price. **Gross profit** is the selling price less the adjusted income tax basis.[52] The selling price is computed without a reduction for any existing mortgage and/or selling expenses. The **total contract price** is the amount to be paid by the buyer and does not include a mortgage except to the extent the mortgage exceeds the income tax basis.[53] The remaining amount of each principal payment is a nontaxable return of basis. Interest received is taxable as ordinary income.

Reporting gain from an installment sale of real property involves a 4-step process.

Step 1. Subtract the seller's adjusted basis in the property from the selling price. This yields the gross profit. In making this computation, sale expenses are added to the property's basis.

Step 2. Compute the total contract price. The total contract price is the amount the buyer pays, less indebtedness. The indebtedness must be qualifying indebtedness that is functionally related to the property. Debt incident to the sale, such as legal fees, does not count.

Step 3. Compute the gross profit percentage by dividing the gross profit by the total contract price.

Step 4. Multiply each payment received by the gross profit percentage. The result is the amount of gain reported for the year.

Example 8. Wilbur Jones is retiring from farming but has no heirs interested in continuing the operation. As a result, Wilbur decides to sell his farm to Tom Tiller in 2012 for $1.325 million. Wilbur agrees to sell the farm on an installment basis and to take annual payments of $66,250 for 20 years with no down payment. Wilbur's basis in the farm is $360,000, and he owns the farm debt-free. The computational process for reporting gain is as follows.

Step 1. Calculate gross profit.

Selling price	$1,325,000
Less: basis	(360,000)
Sale expenses	(26,500)
Gross profit	$ 938,500

Step 2. Determine the total contract price.

Selling price	$1,325,000
Less: qualifying indebtedness	0
Total contract price	$1,325,000

Step 3. Compute the gross profit percentage.

$$\textbf{Gross profit percentage} = \frac{\textbf{Gross profit}}{\textbf{Total contract price}} = \frac{\$938{,}500}{\$1{,}325{,}000} = \textbf{0.7083}$$

52. Treas. Reg. §1.453-1(b)(2)(v).

53. Treas. Reg. §1.453-1(b)(2)(iii).

Step 4. Calculate the amount of each payment received reportable as gain.

Amount received in 2012	$66,250
Gross profit percentage	× 0.7083
Amount reportable as gain	$46,925
Amount representing nontaxable return of basis	$19,325

Note. Payments in the year of sale include a down payment or other payment made in a prior year. The year of sale is generally the year in which the benefits and burdens of ownership pass from seller to buyer. Usually this involves the transfer of possession unless title passes before any other transfer of benefit, in which case the year of title passage is the year of sale. If the seller's indebtedness assumed by the buyer exceeds the income tax basis of the property, the excess is considered a payment in the year of sale.

Minimum Interest Rules

Under the installment sale rules, a part of each principal payment is treated as interest rather than sales proceeds if interest of less than the prescribed "test rate" is specified.[54] Thus, installment obligations are subject to a minimum interest test rate. Under the general rule, when the amount of seller financing in a 2012 transaction is $5,339,300 or less, the test rate is the **lesser** of 9%, or 100% of the applicable federal rate (AFR). When the amount of seller financing for a 2012 transaction is more than $5,339,300, the test rate is 100% of the AFR. The 9% test rate is not available for new property that would have been eligible for an investment tax credit. Any seller financing provided in connection with a sale-leaseback transaction must use a test rate of 110% of the AFR.

The AFR is based on the average yield on federal debt obligations of similar maturity. The short-term rate is for obligations with a term not more than three years, the mid-term rate is for obligations with a term over three years but not more than nine years, and the long-term rate is for a term of more than nine years. The federal rate used is the lowest of the rates in effect as of the first day on which there is a binding contract in writing for the sale or exchange, the rate for the preceding month, or the rate for the second preceding month.

The AFRs from January 2000 through the most recent update can be found at **www.irs.gov.**

Note. In general, both parties are required to account for the interest in seller-financed transactions under the accrual method of accounting. However, if the amount of seller financing is $3,813,800 or less for 2012 (indexed for inflation), both parties may elect to account for interest under the cash method of accounting. The election to report interest on the cash method of accounting is unavailable to dealers or those on the accrual method of accounting.

For sales of land to family members up to $500,000 per calendar year, the interest rate may be set at 6% for federal income tax purposes.[55] Although the IRS accepts the 6% rate for federal income tax purposes, the IRS position (upheld by the 8th and 10th Circuit Courts of Appeal and the U.S. District Court for the Northern District of New York, but not the 7th Circuit) is that use of a rate that is less than a market rate of interest creates a gift.[56] The amount of the gift is the discounted present value of the difference between the market rate of interest and the interest actually charged.

54. IRC §483.

55. IRC §483(e). Under IRC §483(e)(2), spouses of children are not "members of the family."

56. *Schusterman v. Comm'r,* 63 F.3d 986 (10th Cir. 1995), *cert. denied,* 517 U.S. 1208 (1996); *Krabbenhoft v. Comm'r,* 939 F.2d 529 (8th Cir. 1991), *cert. denied,* 502 U.S. 1072 (1992); *Lundquist v. U.S.,* 99-1 U.S. Tax Cas. (CCH) ¶60,336 (N.D. N.Y. 1999); *Ballard v. Comm'r,* 854 F.2d 185 (7th Cir. 1988).

Depreciation Recapture

The buyer may claim depreciation from the date of possession. Recaptured depreciation is taxed to the seller in the year of sale. Depreciation recapture is involved when gain is realized on the disposition of depreciable property.

Example 9. Hammond Beans acquired a tract of farmland and associated buildings on an installment basis in 1992. The purchase price was $100,000. Hammond sold the tract in 2012 for $100,000. During Hammond's period of ownership, he took $40,000 of depreciation on the buildings, subject to §1250 recapture ($10,000 of which was in excess of straight-line depreciation). Thus, upon the sale of the land and buildings in 2012, Hammond recognizes $40,000 of gain. Of that amount, $10,000 of depreciation recapture is ordinary income and the remaining $30,000 is long-term capital gain. The $10,000 of depreciation recapture is reported in the year of sale even if Hammond receives nothing under the contract in that year.

Disposition of the Contract by the Seller

Sale, gift, or other disposition or satisfaction of an installment obligation results in recognition of gain.[57] The privilege of income deferral by installment reporting is generally personal to the party electing the installment method and does not outlast the period during which the obligation is held.

Observation. In essence, almost any transaction the seller engages in triggers tax liability, with the amount of gain or loss being the difference between the basis of the installment obligation at the time of disposition and either the amount realized upon the sale or the FMV of the obligation at the time it is disposed of other than by sale.

There are two exceptions in which a transfer does not require gain recognition.

1. Within the term of the contract when the disposition is on account of death, the tax is not immediately due, **but the installment contract does not receive a new basis.** Payments received after death are treated as income in respect of a decedent, and the recipient reports the income in the same manner as the decedent would have. Disposition of an installment obligation to the obligor after the seller's death results in taxable gain for the deceased seller's estate to the extent of the obligor's ownership share.
2. The other exception is for transfers by one spouse to another or a transfer between ex-spouses incident to a divorce. In this situation, the transferee is taxed on the installment obligation just as the transferor would have been taxed.[58]

Cancellation of the Contract

Cancellation of an installment obligation is treated as a taxable disposition of the obligation by the holder. The amount of the gain is the difference between the FMV of the obligation and its basis if the parties are not related.[59] Thus, if the seller forgives or cancels the obligation to pay amounts due, the result is the same as a disposition of the obligation. If the parties are related, the gain is the difference between the face amount and the basis of the obligation. This is the outcome even if no principal payments are received. The FMV of the obligation is treated as not less than its face value. The IRS has ruled that cancellation of principal to a unrelated party in a debt restructure involving an installment sales contract does not result in income tax consequences to the seller.[60]

---

57. IRC §453B(a).
58. IRC §453B(g).
59. IRC §453B(a)(2).
60. Ltr. Rul. 8739045 (Jun. 30, 1987).

Pledging the Contract

The tax consequences are unfavorable if the seller takes the contract to a lender and pledges the contract on a new loan. In that event, the entire amount of the loan proceeds is treated as a payment on the contract. This is not the case if the interest rates and maturity date differ and the taxpayer does not part with a substantial portion of the ownership rights in the obligation.

> **Note.** For installment obligations above $150,000, pledging installment obligations results in the net proceeds of the secured indebtedness being treated as a payment received, except for personal-use property and farm property.[61]

Related-Party Rules for Installment Sales

For sales between closely related parties, disposition of the property by the purchaser within two years of the original transaction may result in taxable gain to the original seller, except for the following.

- Transfers because of involuntary conversion
- Transfers after the death of the installment seller or purchaser
- Sale or exchange of stock to the issuing corporation
- Transfers in which it is established to the IRS's satisfaction that the disposition did not have income tax avoidance as one of its principal purposes

The disposition of a contract to children in exchange for annuity payments constitutes a taxable disposition. For a disposition by gift, the donee's income tax basis presumably would be the FMV of the obligation inasmuch as the donor's basis would be increased by virtue of the taxable disposition. A tax-free exchange to a corporation or partnership does not trigger taxability for the transferred installment obligations. All potential depreciation recapture on installment sales of real or personal property is taxed to the seller in the year of sale.[62]

For sales of depreciable property between related persons, the deferred payments are deemed received in the taxable year of sale with the gain taxed at ordinary income rates.[63]

THE LIFE ESTATE/REMAINDER TRANSFER STRATEGY

The life estate/remainder is a common estate planning/succession planning strategy. It is a strategy that is often integrated as a component of a succession plan but is typically not the primary focus of the plan. It is also a simple way to own property and move it from one generation to the next. It is a technique often employed in relatively smaller-sized estates, sometimes on an informal basis. Therefore, an understanding of the basics of life estate/remainder arrangements is critical.

The life estate/remainder arrangement is a form of co-ownership that gives both the life tenant and the person(s) holding the remainder interest certain rights to the property. The life tenant has a current right to possession, and the holder of the remainder interest has a right of possession upon the life tenant's death.

Creation and Property Subject to a Life Estate

A life estate can be created by gift or sale (by virtue of a deed), at death under the terms of a will or trust, by state law, or by a settlement agreement in divorce proceedings (or via court order). Most often, life estates are created with respect to real property, but they can also be utilized with personal property and even intangible personal property.

---

61. IRC §453A.

62. This is the outcome even if no principal payments are received.

63. IRC §§453(g) and 1239.

Income Tax Basis

It is important to understand the basis rules associated with life estate/remainder arrangements. Basis is associated with how the life estate was created and acquired.

- For "granted" life estate/remainder arrangements that are created by will or trust, the property is not included in the life estate holder's estate and the life estate property does not receive an FMV basis.
- For "retained" life estates (those created by deed in which the grantor retains the life estate), the full value of the property is included in the grantor's gross estate at death, with the holder of the remainder interest getting a basis equal to FMV at the time of death.
- A carryover basis applies to a life estate/remainder interest that is created by gift.
- For those interests that are purchased, a purchase price basis applies.

> **Note.** To the extent the life tenant claims depreciation during the life tenancy, the uniform basis in the property is reduced accordingly.

- For split-interest purchases of real estate in which, for example, a C corporation acquires an interest in the real estate for a term of years with a shareholder acquiring a remainder interest, the income tax basis of the real estate shifts from the C corporation to the shareholder over time with no income tax consequence.[64]

Tax Issues — Granted Life Estates

As noted earlier, the life tenant has possession of the property subject to the life estate and is entitled to all the income generated by the property. That means the normal tax consequences associated with property ownership are enjoyed by the life tenant. For example, the life tenant is taxed on all the income received from the property and can deduct items attributable to the property such as real estate taxes, mortgage interest, depreciation (if the property is depreciable), and depletion (if the life estate is acquired by purchase).

If life estate property is sold, its income tax basis must be apportioned between the life estate interest and the remainder interest in proportion to the respective present values of the interests, as determined by the IRS valuation tables using the IRC §7520 rate in effect at the time of valuation. This concept is known as "uniform basis."

The share of the uniform basis allocable to each interest is adjusted over time. This will have the following results.

- If only the life estate interest is sold, the life tenant's portion of uniform basis is disregarded for purposes of determining gain or loss.[65] This means that the gain on the sale equals the amount realized on the sale (the sale proceeds). Normally, the gain is capital in nature.

> **Note.** If the life estate property is a personal residence, both the holders of the life estate interest and the remainder interest are potentially eligible for the IRC §121 gain exclusion but have to satisfy the two-out-of-five-year use and occupancy requirement.

---

64. Treas. Reg. §1.1014-5(a)(3). Upon purchase of the real estate, the purchase price is split between the corporation and the shareholder in accordance with the present value tables contained in Treas. Reg. §20.2031-7 (Table B), with the interest rate set in accordance with IRC §7520, which is published monthly by the IRS.

65. IRC §1001(e).

- If both the life estate interest and the remainder interest are sold during the life tenancy, the uniform basis of the property and the sale proceeds must be allocated between the life estate and remainder interests based on their respective values at the time of sale to determine the gain or loss attributable to each respective interest.[66] The gain usually is capital gain.
- If the holder of the remainder interest sells the property **after** the life estate terminates, gain or loss on the sale is determined by subtracting the uniform basis in the property from the amount realized on the sale.

Estate and Gift Tax

A transfer of a life estate by deed during the life tenant's lifetime qualifies as a present interest gift (and qualifies for the marital deduction if transferred to the spouse). However, gifts of successive life estate or remainder interests are future interests that do not qualify for the gift tax present interest annual exclusion. The amount of the gift equals the present value of the interest in the property transferred, as determined under the IRS valuation tables using the IRC §7520 rate in effect at the date of the gift.

> **Note.** Although it is beyond the scope of the discussion here, if the grantor retains certain interests in the property and gifts the other interests in the property to members of the grantor's family, the special valuation rules of IRC §2702 apply.

For retained life estates, the entire FMV of the property is included in the decedent's taxable estate for federal estate tax purposes, and the property receives an FMV date-of-death basis.[67] Similarly, for granted interests in which the grantor retains the life estate, the full value of the property is included in the grantor's taxable estate at death. A life estate transferred to the spouse at death does not qualify for the marital deduction unless it is in the form of a qualified terminable interest property.

Planning Points

The life estate/remainder arrangement is a very simple technique that involves minimal cost. It also avoids probate because the property passes automatically to the holder of the remainder interest. The strategy also protects the property from the creditors of the remainder interest holders during the term of the life estate. However, creditors of remainder interest holders can reach "vested" remainder interests, which can indirectly cause problems for a life tenant wanting to sell or mortgage the property. A **vested** remainder is one that is certain to become possessory in the future. In addition, in some states, the life estate/remainder arrangement can provide some benefit in the event of the need for long-term care when a Medicaid benefit application is filed. Only the value of a retained life estate is counted for benefit eligibility purposes and is subject to Medicaid recovery provisions at the recipient's death.

Alternatively, the life estate/remainder strategy can spur conflicts between the life tenant and the holders of the remainder interest. In addition, neither the life tenant nor the remainder interest holders can independently sell or mortgage the property without the consent of the other.

SUMMARY TABLE

The following table addresses a granted life estate remainder arrangement but does **not** address retained life estates.

66. See Rev. Rul. 72-243, 1972-1 CB 233.

67. IRC §§1014 and 2036.

Uniform Basis Rules for "Granted" Life Estate and Remainder[a]

	Transfer (Grant) Made during Life (Carryover Basis Gift Tax Rules)		Testamentary Transfer (Basis FMV DoD of Grantor)	
	Life Tenant	**Remainderman**	**Life Tenant**	**Remainderman**
Original basis at time of transfer	Uniform basis rules using carryover basis — gift tax rules (Treas. Reg. §1.1015-1(b))	Uniform basis rules using carryover basis — gift tax rules (Treas. Reg. §1.1015-1(b))	Uniform basis rules using FMV DoD (Treas. Reg. §1.1014-4)	Uniform basis rules using FMV DoD (Treas. Reg. §1.1014-4)
During life tenant's life	Entitled to depreciation (Treas. Reg. §1.1014-4(b))	No depreciation while life tenant living	Entitled to depreciation (Treas. Reg. §1.1014-4(b))	No depreciation while life tenant living
Complete sale by life tenant and remainderman during life tenant's life	Allocate: sale price, basis (Determined Treas. Reg. §1.1014-5)	Allocate: sale price, basis (Determined Treas. Reg. §1.1014-5)	Allocate: sale price, basis (Determined Treas. Reg. §1.1014-5)	Allocate: sale price, basis (Determined Treas. Reg. §1.1014-5)
Sale by life tenant during life tenant's life	Allocated but disregarded[b] (Treas. Reg. §1.1014-5)	Allocated (Treas. Reg. §1.1014-5)	Allocated but disregarded[b] (Treas. Reg. §1.1014-5)	Allocated (Treas. Reg. §1.1014-5)
Sale by remainderman during life tenant's life	Allocated (Treas. Reg. §1.1014-5 rules)	Allocated (Treas. Reg. §1.1014-5 rules)	Allocated (Treas. Reg. §1.1014-5 rules)	Allocated (Treas. Reg. §1.1014-5 rules)
Death of life tenant before remainderman	Not subject to estate tax. Life estate terminates. No step-up basis.	100% remaining basis (after depreciation taken while life tenant alive). No step-up basis.	Not subject to estate tax. Life estate terminates. No step-up basis.	100% remaining basis (after depreciation taken while life tenant alive). No step-up basis.
Death of remainderman before life tenant	N/A	No adjustment to uniform basis, but heir's basis determined by adding to or subtracting from adjusted uniform basis assigned to remainder interest the difference between DoD value of remainder interest and basis of remainder interest before remainderman's death.[c]	N/A	No adjustment to uniform basis, but heir's basis determined by adding to or subtracting from adjusted uniform basis assigned to remainder interest the difference between DoD value of remainder interest and basis of remainder interest before remainderman's death.[c]
Death of remainder-man after life tenant dies	N/A	Basis FMV 100% ownership (IRC §1014)	N/A	Basis FMV 100% ownership (IRC §1014)

[a] This table does not apply to lifetime transfers with retained life estates. It does apply, however, to split interests whether created by deed, trusts or wills.
[b] IRC §1001(e).
[c] Treas. Reg. §1.1014-8(a)(1).

5

DYNASTY (PERPETUAL) TRUSTS AS PART OF SUCCESSION PLANNING

Note. For additional information on dynasty trusts, including an example, see pages 408–410 of the 2011 *University of Illinois Federal Tax Workbook.*

OVERVIEW

While the federal estate tax only impacts a very small minority of individual's estates at the time of death, it is a significant factor for many small businesses. Many family businesses face the prospect of the federal estate tax being imposed at the death of the owner/operator. There are, however, various planning techniques that can be utilized to minimize the potential impact of the tax. Those techniques include entity planning and valuation discounting, establishing a program of gifting business interests during life, setting up life insurance as a future pool of funds to pay anticipated costs and taxes at death, and the use of trusts.

One of the most useful types of trusts that can be utilized as a succession planning/creditor protection device is the so-called "dynasty" or perpetual trust. The primary benefit of such a trust is that it can keep the family business and personal assets in the family for multiple generations with no tax incurred as the property passes from one generation to the next.

A dynasty trust allows high-wealth clients to provide for multiple generations of lineal descendants. The trust is structured to last the maximum term permitted by state law and to allow trust assets to avoid transfer taxes and achieve asset protection for the term of the trust.

Observation. Generation-skipping tax planning via the use of a dynasty trust should not be viewed as only for very wealthy clients. The technique can be a valuable tool for those with modest estates. The trust can provide for the tax-free growth of assets, which can be significant even if only for one generation.

The dynasty trust is an irrevocable trust that includes a "spendthrift" provision designed to protect the trust assets from irresponsible actions of the beneficiaries, former spouses, creditors, and legal action.

Because the initial funding of the trust is designed to take advantage of the grantor's transfer tax exemption amount ($5.12 million estate and gift tax exemption for 2012), the enhanced amount of the exemption for 2012 provides a critical window of time to fund a dynasty trust for certain clients. If the trust is funded with property worth more than the existing exemption equivalent, the transfer is subject to gift tax (or estate tax if funding occurs at the death of the grantor). If structured properly, the trust can pass from generation to generation without incurring estate tax or GSTT.

The GSTT is a complex tax that is imposed on outright gifts or transfers in trust to related persons who are more than one generation younger than the donor, such as a gift made directly to grandchildren by a grandparent. The GSTT is imposed if the transfer avoids either a gift or estate tax at each generation level. However, the tax is only imposed on the amount of assets in excess of the GSTT exemption. For 2012, the GSTT exemption is $5.12 million and the GSTT tax rate is 35%.[68]

Note. Absent Congressional action, effective January 1, 2013, the GSTT exemption will be $1 million and the GSTT rate will be 55%.

68. As provided for in the Tax Relief, Unemployment Insurance Authorization, and Job Creation Act of 2010, PL 111-312 (Dec. 17, 2010).

Observation. In 2009, the applicable exclusion was $3.5 million. Thus, assume a grantor funded a dynasty trust in 2009 with $3.5 million of property. If a net investment return (after distribution to beneficiaries) of 3% is assumed, after 90 years the trust property will be worth $50 million. If the trust is funded with the full exclusion amount of $5.12 million in 2012, after 90 years and assuming a net investment return of 3%, the trust assets would be worth $73.2 million. For married couples, the initial $5.12 million investment can be doubled to $10.24 million without gift tax consequences.

A dynasty trust helps take full advantage of any subsequent changes in transfer tax laws that may occur in the future; in particular, gift tax is avoided. Distributions from a dynasty trust are not taxable gifts. Thus, trust distributions can be made when desired without the imposition of gift tax. All of this can be accomplished in addition to providing asset protection from creditors.

TAX ASPECTS

The basic intent of a generation-skipping trust is to avoid the GSTT. If the trust is not set up properly, it incurs GSTT taxable terminations and distributions as the years pass. However, the trust is not subject to GSTT if the grantor allocates enough GSTT exemption to make the inclusion ratio zero. Although the grantor's unified estate and gift tax exemption (for 2011 and 2012) is automatically allocated to the transfer of property to the trust, the grantor must elect to allocate the GSTT exemption to transfers. Typically, this is the value of the property that funds the trust via gift ($5.12 million for 2012 unless a split-gift election is made).

Note. If the trust authorizes additional property to be transferred to the trust, such authorization should allow the trustee to segregate GSTT-exempt property from nonexempt property that is put in the trust so as to maintain the GSTT inclusion ratio at zero.

The trust is treated for tax purposes as an irrevocable trust. This means that the initial funding of the trust is subject to gift tax and uses up the grantor's unified credit to the extent of the excess over the present interest annual exclusion. If the donor does not retain any power over or interest in the trust, the property transferred to the trust is not included in the donor's gross estate at death. If the trust is structured as a grantor trust, the income in the trust accumulates tax-free. Under the grantor trust rules, the settlor (rather than the trust) is taxed on trust income and gains during the settlor's lifetime. The settlor can also sell appreciated assets to the trust without incurring capital gain tax.

Note. Grantor trust status can be achieved if the terms of the trust give discretion over distributions of income and principal that can be exercised by a majority of trustees who are related or subordinate to the settlor.

Example 10. Bill, age 70, has $10 million in assets that he accumulated over his lifetime, including a vending machine business valued at $3 million. He would like to leave some of his assets to his son, granddaughter, and all of their future children. The assets he would like to pass on include the vending machine business.

In 2012, Bill establishes a dynasty trust, and in addition to the vending machine business, he selects another $2.12 million of assets to transfer into the trust. This serves to transfer a total of $5.12 million into the trust, which allows Bill to fully utilize his GSTT exemption. As long as these assets remain in the dynasty trust, the trust assets will not become part of any family member's estate.

Because Bill wants this estate planning advantage to last for many generations, it is essential that he establish the dynasty trust in a state that allows a trust to exist for several generations instead of only for a limited number of years. For all the generations of Bill's family for which the dynasty trust exists, the assets that Bill transfers into the trust, the growth in value of those assets, and all income accumulated within the trust avoid the GSTT.

TRUST TERM

The maximum trust term is tied to a particular state's rule against perpetuities. Under the common-law version of the rule, the transfer of a property interest is of no effect unless it vests (e.g., when a right in property is legally recognized and cannot be taken away by a third party) no later than 21 years after some "life in being" at the creation of the interest. The "life in being" could be the lifetime of the grantor, a beneficiary, or other specified individual. This person's life serves as the "measuring" life of the trust or other arrangement that is subject to the rule against perpetuities.

> **Note**. The rule against perpetuities was a legal rule created in 17th century England. It was developed by courts to prevent a person from using entities such as a trust to maintain control over assets after death for many generations. This practice was viewed as a restraint on the ability to sell or transfer assets still under the control of a decedent. Many states continue to adopt this legal rule, while others have changed it to allow longer periods of time that are more favorable for the use of longer-term succession planning tools such as a dynasty trust.

Initially, every state prohibited a trust from lasting longer than 21 years after the death of the last beneficiary alive at the time the trust was created. However, the rule against perpetuities has been modified or abolished in numerous states. Presently, 23 states and the District of Columbia have either modified or abolished the historic rule against perpetuities.[69] Trusts established in those states can benefit from the repealed or modified rule. The typical requirements to establish a trust in a particular state include the use of a trustee from that state and the transfer of custody of some or all of the assets to that state.

> **Note.** It is generally desirable to have the trust situs in one of the states that has repealed the rule against perpetuities. The trust instrument should state that its validity, construction, and administration is governed by the law of that state. The trust should have some relationship with the state to make such a choice effective. This can be accomplished by appointing a trustee who is located in a jurisdiction with a favorable perpetuities law. This clearly is successful for personal property, but real property is governed by the law of the state in which the real estate is located. In such a situation, it may be advisable to keep the real estate out of the trust.

> **Caution.** The Obama Administration's 2012 budget proposal includes a provision that would limit dynasty trusts to 90 years.

TRUSTEE CONSIDERATIONS

Given the long-term nature of a dynasty trust, the settlor carefully selects the initial and subsequent trustees. Additionally, the trust language that empowers trustees beyond those named in the trust instrument must be carefully drafted. Because of the duration of the trust, it is important to utilize trust language that places appropriate limits on the trustee's exercise of power. It is likewise important to establish a process through which trustees will ultimately be replaced.

---

69. The following states in addition to the District of Columbia permit perpetual trusts: Alaska, Arizona, Colorado, Delaware, Idaho, Illinois, Maine, Maryland, Missouri, Nebraska, New Hampshire, New Jersey, Ohio, Pennsylvania, Rhode Island, South Dakota, Virginia and Wisconsin. The following states permit trusts with a long (but not perpetual) duration: Florida (360 years), Nevada (365 years), Utah (1,000 years), Washington (150 years), and Wyoming (1,000 years).

The trustee has a fiduciary relationship with the trust beneficiaries, and an action for removal can be brought by aggrieved beneficiaries as a "for cause" action under common law principles. Some trusts contain language providing for trustee removal without cause. However, most courts require that the trustee commit a serious breach before removal is allowed. Also, some states have statutory procedures for removing a trustee under the Uniform Trust Code (UTC), which was adopted in 20 states and the District of Columbia.[70] One of the UTC mechanisms for trustee removal does not hinge on trustee conduct. Instead, beneficiaries may request trustee removal if "there has been a substantial change of circumstances or removal is requested by all of the qualified beneficiaries, the court finds that removal of the trustee best serves the interests of all of the beneficiaries and is not inconsistent with a material purpose of the trust, and a suitable co-trustee or successor trustee is available."

The trustee's retained power to appoint a successor/substitute trustee does not cause inclusion of the trust assets in the settlor's gross estate for estate tax purposes if the exercise of the power resulted from a vacancy or court-ordered removal. A broad removal power can cause the trust assets to be included in a beneficiary's bankruptcy estate. Property of the estate does not include any power that the debtor may exercise solely for the benefit of an entity other than the debtor.[71] Thus, any power that the debtor holds that can be exercised for the debtor's personal benefit is considered property that is includible in the debtor's bankruptcy estate.[72] Likewise, the power of removal does not cause inclusion in the gross estate unless it is tied to a power to appoint.[73] In addition, a reserved power for substitution without cause is permissible if the substitute trustee is not related or subordinate to the settlor as defined by IRC §672(c).[74] Consequently, the settlor can choose from a rather large pool of candidates to serve as substitute trustee.

Note. Apparently, a trustee substitution power held by a beneficiary is also permissible. Although such a power can amount to a general power of appointment, Rev. Rul. 95-58[75] did not distinguish between a reserved substitution power held by the settlor and one held by a beneficiary after the settlor's death.

STRUCTURE OF THE TRUST

A GST or dynasty trust can be structured in various ways. Commonly, the trust is drafted in the form of a spendthrift trust in order to provide asset protection. A spendthrift provision prevents a beneficiary from assigning, transferring, or encumbering an interest in the net income or principal of the trust. Creditors of a beneficiary cannot attach a beneficiary's interest in the trust until there is a distribution to the trust (except for child support or spousal support). However, a spendthrift provision also gives the trustee absolute discretion over distributions. Consequently, a settlor's goal of asset protection can only be accomplished by giving the trustee greater discretion over trust assets.

70. States that adopted the Uniform Trust Code are: Kansas, Nebraska, Wyoming, New Mexico, Utah, Maine, Tennessee, New Hampshire, Missouri, Arkansas, Virginia, South Carolina, Oregon, North Carolina, Alabama, Florida, Ohio, Pennsylvania, North Dakota, Arizona, and the District of Columbia. See UTCProject.Org. National Conference of Commissioners on Uniform State Laws. [www.utcproject.org] Accessed Aug. 2, 2012.

71. 11 USC §541(b)(1).

72. See *Collier on Bankruptcy,* 541.11(2).

73. Rev. Rul. 79-353, 1979-2 CB 325.

74. Rev. Rul. 95-58, 1995-2 CB 191.

75. Ibid.

The following are some of the more popular forms of a dynasty trust.[76]

- **For the benefit of the grantor's children.** This form allows the trustee to make discretionary distributions of income and principal to the children for their lives as part of a single trust fund. Upon the death of each child, that child's children become lifetime beneficiaries. This process repeats itself at each generation. If (or when) the trust terminates, the trust assets are split among the income beneficiaries either on a per stirpes or per capita basis.

  The terms refer to how a decedent's assets are distributed. With a per stirpes distribution, each **branch** of the family receives an equal share of the estate. When an heir in the first generation of a branch dies before the decedent, the share that would have been given to that heir is distributed among the heir's issue in equal shares. For example, the trust could be divided equally among a class of survivors of the oldest generation and decedents of that generation having then-living descendants. The share of a deceased member of the oldest generation would then be distributed to the deceased member's living descendants, per stirpes. Under a per capita distribution, members of the same generation may inherit different amounts.

- **Children and grandchildren as simultaneous beneficiaries.** This type of trust contains language that creates a separate share for each beneficiary and descendants. When a child dies, that child's separate share trust is divided into as many shares as necessary to create a share for each then-living grandchild and one share for any predeceased grandchild that left descendants. The trust directs the trustee to distribute income and principal to each beneficiary. Each beneficiary is given a general power of appointment (subject to federal estate tax).

- **"Pot trust."** With this approach, the trustee is authorized to distribute principal and income among the grantor's descendants at the trustee's discretion.

ASSET PROTECTION

Trusts are often created to protect assets from the claims of creditors (and former spouses) as well as shield assets from depletion caused by paying for long-term health care. In recent years, many states have amended their laws to make it possible to create trusts that are capable of asset protection. Dynasty trusts, if drafted properly, can accomplish asset protection along with favorable tax treatment.

The key to accomplishing asset protection is limiting access to trust assets by the beneficiaries. In turn, limited access is dependent on the terms of the trust. Those terms can be as broad or narrow as the grantor desires.

- Provisions can be included that give the beneficiaries broad powers such as naming the beneficiary as trustee, the right to all income, and the right to consume principal limited by ascertainable standards such as health, education, maintenance, and support. However, the asset protection characteristic of the trust can be lost if the beneficiaries are given too much power, such as the ability to select a compliant trustee who will succumb to pressure from the beneficiaries to make distributions or terminate the trust. In this situation, other trust terms can be included to help minimize the impact of an inappropriate trustee appointment. Also, the beneficiary can be given even more control by granting a special (or limited) testamentary power of appointment. This power can include the power to name successive beneficiaries but not the power to appoint trust income and/or corpus to the beneficiary, the beneficiary's creditors, estate, or creditor of the beneficiary's estate.

- Provisions that restrict the power of a beneficiary include the naming of an independent trustee who is vested with sole discretion over distributions coupled with a spendthrift provision. That gives the trustee full authority to determine whether distributions of income or principal should be made to a beneficiary. Such a spendthrift provision can also be used to preserve assets in the event of the beneficiary's need for long-term health care and the need to protect assets from being depleted by paying for long-term care.[77]

---

76. Based on comments contained in Esperti, Peterson and Keebler, *Irrevocable Trusts: Analysis with Forms*, Thomson/RIA.

77. See, e.g., *Biagetti v. Rhode Island Department of Human Services* (R.I. Super. Ct., Feb. 25, 2011). The settlor of the trust was not qualified for Medicaid because the trust for which the settlor was the beneficiary was a countable resource. The trust was a support trust rather than a spendthrift trust; the trust terms indicated that the trustee had to first provide for settlor's well-being during the settlor's lifetime.

- The grantor's children and more remote heirs can be given sufficient rights in their particular shares of the trust such that the beneficiary has, in essence, outright ownership of their share of the trust assets. Such rights can include the ability to control investments, the power to remove and/or replace a trustee, the power to direct trust distributions to others, or the power to serve as a co-trustee. None of these powers, if exercised, are subject to tax or make the trust assets subject to creditor claims.
- Beneficiaries can also be given substantial benefits in addition to outright distributions and still have trust assets shielded from creditors and transfer taxes. Such benefits could include, for example, the use of trust property, trust guarantee of loans of the beneficiaries, and trust investment in a beneficiary's business.

Observation. Clearly, the greater the restrictions on a beneficiary's ability to access trust property and income, the less likely it is that creditors will be able to reach the trust property.

TRUST PROTECTOR

Many dynasty trusts also include a provision for a "trust protector." This is a third party that is responsible for monitoring the administration of the trust to make sure that appropriate decisions are made. The UTC does not refer to "trust protector." However, the UTC defines the role as "the power to direct certain actions of the trustees," and presumes that fiduciary duties apply.[78] The trust protector has the ability to change the trustee, if necessary, and amend the trust's provisions. A trust protector is vitally important in assisting with the administration of the trust. The trust protector can be vested with the authority to address trust amendments, change the trust situs, and replace the trustee. These provisions all help make the trust adaptive to changes in governing law and economic conditions.

Note. The UTC allows for modification of trusts in the event of changed circumstances. Thus, the UTC makes it unlikely that assets could be trapped in trusts in perpetuity, even if the rule against perpetuities was fully repealed. For example, the comments to UTC section 401 ("Modification or Termination Because of Unanticipated Circumstances or Inability to Administer Trust Effectively") states: "Owners may deal without restraint with their own property but not when impressed with a trust for the benefit of others. . . Thus, attempts to impose unreasonable restrictions on the use of trust property, such as a provision severely impairing the use of real property, will fail."

Many states have statutes that delineate a trust protector's powers. The South Dakota statute provides as follows.

The powers and discretions of a trust protector shall be as provided in the governing instrument and may, in the best interests of the trust, be exercised or not exercised in the sole and absolute discretion of the trust protector and shall be binding on all other persons. Such powers and discretion may include the following:

1. *To modify or amend the trust instrument to achieve favorable tax status or because of changes in the Internal Revenue Code, state law, or the rulings or regulations thereunder;*
2. *To increase or decrease the interests of any beneficiaries to the trust; and*
3. *To modify the terms of any power of appointment granted by the trust.*

However, a modification or amendment may not grant a beneficial interest to any individual or class of individuals not specifically provided for under the trust instrument.

---

78. National Conference of Commissioners on Uniform State Laws, *Uniform Trust Code* §808(d).

Similarly, the trust can contain a provision that gives each successive generational beneficiary a limited power to appoint the property among that beneficiary's descendants and (possibly) spouse. The power provides the descendants with greater ability to respond to changed circumstances, and the limited nature of the power does not cause the property subject to the power to be included in the holder's gross estate at death.

Depending on state law, in general, trust protectors enjoy liability protection for action or inaction associated with the trust. It may be an open question as to whether a trust protector is a fiduciary with a duty of loyalty. In a minority of cases, the trust protector was held to **not** be a fiduciary. Most courts hold that there is a duty of the trust protector to act in the best interests of the beneficiaries and a requirement to act with loyalty. Thus, it may not be possible for the trust terms to completely insulate the trust protector from liability. Clearly, the liability of a trust protector can be limited but completely eliminating potential liability may not be possible.

SUMMARY POINTS

- The only limitation on duration of the dynasty trust is the particular state's rule against perpetuities.
- Although gift tax may be due on funding (or estate tax if funding occurs at death), no further tax should be triggered.
- The trust can be drafted to provide for the grantor's children and subsequent descendants, and the trust can specify what happens upon trust termination.
- The trust can be set up as a "pot" trust or may contain separate shares for the beneficiaries.
- The grantor should not retain any power over or interest in the trust so that the trust property is not included in the grantor's gross estate.
- To avoid income tax complications, the trust should be structured as a grantor trust.
- The trust should contain provisions for the removal and replacement of the trustee and should provide for continuity of the trustee.

THE ROLE AND USE OF LIFE INSURANCE IN SUCCESSION PLANNING

Life insurance plays an important role in succession planning. For many businesses, life insurance provides liquidity at death that can fund a buy-out, help provide asset protection, provide income for nonbusiness heirs, and provide a tax-favored way to assist in the transition of a business from one generation to the next.

IRREVOCABLE LIFE INSURANCE TRUST

Presently, life insurance enjoys "tax-favored" status. If the federal estate tax is repealed (along with the stepped-up basis rule of IRC §1014), life insurance will become even more attractive. Furthermore, if a policy is owned by an irrevocable life insurance trust (ILIT), death benefits can be received without being subject to estate tax or GSTT.

An ILIT is both owner and beneficiary of one or more life insurance policies. The ILIT cannot be amended once established. After the death of the insured, the ILIT receives the life insurance proceeds, and the trustee of the ILIT invests the insurance proceeds. The trustee administers the trust for one or more beneficiaries.

As a business succession planning tool, an ILIT can make the proceeds payable to the business owner's estate via loans or by buying assets from the estate at FMV. The ILIT can also be set up to buy the decedent's closely held business interest at a discount, which effectively redeems the business interest and freezes the value of the surviving spouse's estate. This is because the closely held business interest purchased by the ILIT does not pass outright (or in a marital deduction trust) to the surviving spouse. As a result, cash received by the surviving spouse can be used to make gifts to nonbusiness heirs and/or fund an ILIT for the benefit of the nonbusiness heirs.

Example 11. Norine, age 47, is in good health and is a successful interior designer in New York. Norine's only major asset is her business. She has two adult children and no spouse. Her daughter, Clementine, works full time with Norine in the interior design business. Her son, Jacob, however, is not involved in the business and is studying journalism at City University of New York. He plans to begin a career in journalism after graduation. Although Norine has a succession plan in place to pass on the interior design business to her daughter, she is concerned that her planning will leave little or nothing to be passed to Jacob. She would like to treat each child equally but realizes it makes no sense to pass any of the business on to Jacob, who has other career interests.

Norine decides to establish an ILIT. It is structured in a manner to ultimately benefit Jacob at Norine's death. She obtains an amount of insurance that she believes will equal the value of the business. For the face amount of the insurance policy, she can use an estimated value for the business based on her life expectancy or other amount she feels is appropriate. She is still young and healthy enough for life insurance to be cost effective for this purpose. The ILIT will own the life insurance policy and will also be the beneficiary on the policy.

Norine names her sister, Luella, as trustee of the ILIT. At Norine's death, Clementine will receive the business and Jacob will receive the life insurance proceeds from the ILIT. Norine uses an ILIT as an **equalization tool** to treat both children on more equal terms. After Norine's death, Jacob could use some or all of the insurance proceeds to purchase an interest in the family business from Clementine if both siblings agree.

ILIT BASIC PLANNING POINTS

Under an ILIT, the policy death benefits are held in the trust at the time of the policy owner's death, and when funded, allow the use of the grantor's gift tax and GSTT exemption. In addition, multiple beneficiaries can have an interest in the death benefits. However, the key to effective use of an ILIT is flexibility in the terms.

Flexibility in drafting focuses on a few key areas. One of those areas concerns donor powers. Allowing the donor to change which beneficiaries will receive *Crummey* withdrawal powers[79] on an annual basis is important. Similarly, the use of tiered *Crummey* powers such as allowing the grantor's spouse to withdraw first followed by the donor's children can be beneficial. Such powers can allow the beneficiaries holding contingent remainders to have a vested interest in the trust.

Other drafting provisions may involve the inclusion of a "five-and-five power" in accordance with IRC §2514. A five-and-five power is a common clause included in many trusts allowing for beneficiary withdrawals from the trust for the greater of $5,000 or 5% of the trust's FMV each year. Such a power can be applied to the entire ILIT rather than simply against gifted amounts contributed to the trust. An ordering rule can be utilized for a donee that holds multiple withdrawal rights so as to avoid violating the five-and-five safe harbor lapse amount. In addition, a special powerholder can be appointed that has a limited power to appoint trust property during the grantor's lifetime.

Observation. *Crummey* demand powers and five-and-five powers are two very common forms of withdrawal rights granted to trust beneficiaries. In the succession planning context, such powers allow income and business interests to be transferred from the owners of the business to the successors without gift tax complications or adverse estate tax complications by using the present interest annual exclusion.

79. A *Crummey* power is named after a 1968 federal court opinion (*Crummey v. Comm'r,* 397 F.2d 82 (9th Cir. 1968)) that allowed contributions to an irrevocable trust to qualify for the annual gift tax exclusion because the beneficiaries (typically the donor's grandchildren) are given an unrestricted right to withdraw for a specified period of time. The *Crummey* power has become a standard estate planning tool, the benefits of which increase through leveraging the annual exclusion to maximize the amount of gift-tax-free transfers to an irrevocable trust.

Beneficiaries can be given testamentary limited powers of appointment, and the grantor, grantor's spouse, and beneficiaries can be given the power to change the trustee. Likewise, the trustee can be given the discretionary power to satisfy *Crummey* notice requirements. Furthermore, the *Crummey* withdrawal powers can be allowed to be satisfied against trust property, including insurance policies, and the trustee can be given the power to appoint a guardian for minors who are likely to receive a *Crummey* withdrawal right.

Other benefits of an ILIT in succession planning include the following.

- It provides wealth replacement for the business owner's estate.
- It can aid in estate equalization between the business owner's heirs.
- It serves as an inheritance for nonbusiness heirs.
- It helps to avoid the buy-out of nonbusiness heirs.
- It helps fund buy-sell agreements.
- It provides a tax hedge to the business owner.
- It provides a predictable result regardless of what happens with the federal estate tax.
- It provides retirement income to the business owner by allowing the business owner to borrow the built-up cash value, withdraw cash value, sell the policy in the life settlement market (although tax is triggered), or fund an IRC §303 stock redemption.
- If the ILIT is structured correctly such that the policy proceeds are not included in the decedent's gross estate at death, the decedent's estate may more easily qualify for certain post-mortem estate planning techniques.
- In conjunction with a nonqualified deferred compensation plan (NQDC), an ILIT can be used by the business to provide senior members with death, disability, and retirement benefits. This can also help ensure that key employees remain during the transition period.

CORPORATE REDEMPTIONS AND BUY-SELL AGREEMENTS

REDEMPTIONS

Passing an incorporated business to the next generation may be accomplished in a transaction involving a stock redemption. In a **redemption** transaction, a shareholder who owns corporate shares exchanges those shares with the corporation in return for cash or other property. Generally, in a redemption transaction, if a shareholder fully relinquishes an interest in the corporation, this may qualify for sale or exchange (capital gain) tax treatment. However, if the shareholder only redeems some of the shares and continues to retain an interest, the transaction may be characterized as a distribution and will be taxed as such. IRC §302 contains provisions that differentiate these two types of redemptions and require a redemption to meet specific tests to qualify for more favorable capital gains tax treatment. Totally relinquishing shares to qualify for capital gains tax treatment is particularly problematic under §302 for a shareholder in a family business because of the applicable shareholder attribution rules. A parent can redeem all of their shares and still be considered the owner of other family members' shares. Despite the full relinquishment, the transaction may be treated instead as a distribution because of this. However, §302(c) provides some tests that, if met, can allow a fully redeeming family member to disregard the attribution rules and obtain capital gains tax treatment on the share redemption.[80] These tests include an agreement by the redeeming shareholder to refrain from being an officer or employee of the corporation for a period of time after redeeming shares or reacquiring an interest in the corporation.

80. See IRC §302(c) and Treas. Reg. §1.302-4 for further details on requirements that must be met for capital gains treatment with related shareholders.

In a recent IRS letter ruling,[81] the IRS determined that a father's transfer of corporate business interests to his children via gifts and a redemption could be accomplished in a tax-favored manner. The father was the sole owner of the business that had a single class of issued and outstanding voting common stock. He was retiring and sought to transfer the business to his two children.

Initially, he gifted shares to the children followed by a corporate redemption of his remaining shares in return for cash and a promissory note providing principal and interest on a monthly basis. The IRS determined that the redemption could qualify as a complete termination of the father's interest and would not be treated as a taxable dividend distribution as long as the requirements of IRC §302(c)(2) were satisfied. Although the father must recognize gain on the redemption equal to the difference between the redemption price and the adjusted basis of the shares of stock, the gain would be capital gain (favorable tax rate) to the extent that the corporate stock is a capital asset in the father's hands. In addition, the gain would be reportable on the installment method, and the corporation would not recognize gain or loss on the distribution of the promissory note in redemption of the corporate stock.

The IRS also noted that if the redemption was not undertaken to fulfill an unconditional obligation of either child to acquire the father's stock, there would not be any income deemed to be constructively received by the children. Any interest the corporation paid on the note would be deductible and no imputed interest would attach to the note. The end result was an extremely tax-efficient transfer of the business from the father to the children.

BUY-SELL AGREEMENTS

Buy-sell agreements can be very important to ensuring a smooth transition of the business from one generation to the next. A buy-sell agreement is a contract between business owners, or between a business and its owners, governing the sale of business interests in certain circumstances. A well-drafted buy-sell agreement can help prevent problems from arising that could disrupt the succession of the business because of death, divorce, or internal turmoil. Depending on the language of the agreement, a buy-sell agreement can trigger the sale of a business interest in a variety of voluntary or involuntary circumstances. Such triggering events can include (among other things) a career change, retirement, disability, bankruptcy, or divorce.

Buy-sell agreements (as well as purchase options) have as their primary objective holding the business together and concentrating complete ownership in the hands of successors.

> **Observation.** An alternative (or supplement) to a buy-sell agreement is that a successor can be given an option via contract or will of the current business owner to purchase interests of nonoperator heirs at a specified value. The option price should be established in good faith and supported by adequate and full consideration. Otherwise, the IRS can disregard it as a device to pass property to the decedent's family for less than a fair value.[82]

To make the agreement operational, it is typically funded by life insurance. The type of buy-sell agreement utilized and the drafting of the buy-sell agreement are fundamentally associated with their ability to accomplish specific objectives.

81. Ltr. Rul. 201228012 (Mar. 27, 2012).

82. Treas. Reg. §20.2031-2(h).

TYPES OF BUY-SELL AGREEMENTS AND INCOME TAX CONSEQUENCES

There are generally three types of buy-sell agreements used in C corporation buy-outs.

1. **Redemption agreement (a.k.a. entity purchase).** This type of agreement is a contract between the business and its owners. Each owner agrees to sell their interest to the business on the occurrence of certain events.

2. **Cross-purchase agreement.** This type of agreement is a contract between or among the owners, with each owner agreeing to sell their shares to the other owners on the occurrence of specified events. The business is not necessarily a party to the agreement.

3. **Hybrid agreement.** This type of agreement is a contract between the business and its owners, with the owners agreeing to offer their shares first to the corporation and then to the other owners on the occurrence of certain events.

For redemption agreements, if IRC §§302(b) and 303 are not satisfied, the redemption is taxed as a dividend distribution (ordinary income) to the extent of the stockholder's allocable portion of current and accumulated earnings and profits, without regard to the stockholder's basis in their shares.

Observation. This can be a significant problem for post-mortem redemptions because the estate of a deceased shareholder normally receives a basis in the shares equal to their value on the date of death or the alternate valuation date. Thus, dividend treatment can result in the recognition of the entire purchase price as ordinary income to a redeemed estate. With a stepped-up basis, a sale or exchange results in recognition of no taxable gain whatsoever.

For cross-purchase agreements, unless the shareholder is a dealer in stock, any gain on the sale is a capital gain regardless of the character of the corporation's underlying assets.[83] For the estate that sells the stock shortly after the shareholder's death, no gain is recognized if the agreement sets the sale price at the date of death value.[84] The purchasing shareholders increase their basis in their total holdings of corporate stock by the price paid for the shares purchased under the agreement, even if the shares are purchased using tax-free life insurance proceeds.

A hybrid agreement requires the corporation to redeem only as much stock as qualifies for sale or exchange treatment under IRC §303 and then requires the other shareholders to buy the balance of the available stock. This permits the corporation to finance part of the purchase price, to the extent required to pay estate taxes and expenses, and ensures sale or exchange treatment on the entire transaction.[85]

Note. Under a "wait-and-see" type of buy-sell agreement, the identity of the purchaser is not disclosed until the actual time of purchase as triggered in the agreement. The corporation has the first right of first refusal (or option) to purchase shares. Next, the remaining shareholders may have the second option to purchase shares. Finally, the corporation may be obligated to buy any remaining shares.

83. IRC §1221.

84. IRC §§1014 and 2032.

85. IRC §303(b)(3).

MECHANICS OF THE APPROACHES

The corporation can buy a life insurance policy on the life of each stockholder, with the corporation as the policy owner, premium payor, and beneficiary of these policies. The corporation can then use the life insurance proceeds to finance the purchase. At the end of the first option period, the corporation has the funds to buy the deceased stockholder's interest. The corporation can lend the insurance proceeds to the stockholders. To the extent that there are shares available for purchase after the corporation exercises its option, the remaining shareholders can borrow insurance proceeds from the corporation to make their purchases. Investment payments are deductible to the stockholders and income to the corporation.

An alternative approach is for each shareholder to buy, pay for, own, and become the beneficiary of a life insurance policy on the lives of each of the other shareholders. The surviving shareholders then receive the proceeds when one shareholder dies, and, if a cross-purchase is indicated and appropriate, use the proceeds to fund the buy-sell agreement. This type of arrangement is commonly limited to situations in which there are only a few owners. An advantage of this type of arrangement is that the policy proceeds are not included in the decedent's estate.[86] The surviving shareholders can also lend the proceeds to the corporation if an entity purchase agreement is utilized. This enables the corporation to buy additional shares. Furthermore, the surviving shareholders can make capital contributions which have the effect of increasing each shareholder's stock basis.

> **Observation.** A combination of the above approaches can be used to fund the "wait-and-see" buy-sell agreement. For example, the corporation can own cash-value life insurance, and the owners can own term insurance. Additionally, the parties can have a split-dollar arrangement whereby the corporation pays for the cash-value portion of the premiums and the shareholders own the policy and pay for the term portion of the premiums, with the proceeds split between them.

A buy-sell agreement that imposes employment-related restrictions may create ordinary compensation income without recovery of basis.[87] However, an agreement containing transfer restrictions that are sufficient to render the stock substantially nonvested (substantial risk of forfeiture) may prevent the current recognition of ordinary income.

ADVANTAGES AND DISADVANTAGES OF BUY-SELL AGREEMENTS

A well-drafted buy-sell agreement is designed to prevent the sale (or other transfer) of business interests outside the family unit. In general, a buy-sell agreement is a relatively simple agreement. It is a contract between family members. There are few formalities to follow under state law and no filing or registration fees.

Some of the common advantages of a buy-sell agreement are as follows.

- It creates a ready market for an owner's interest, easing the liquidity problems created by the ownership of a block of closely held business interests at the owner's death.
- If the buy-sell is drafted properly, it can help establish the value of the business interests.
- It can provide the necessary funds to create an FMV exchange.
- It can promote an equitable and orderly transfer of wealth, ownership, and management to the next generation of owners.
- For nonbusiness heirs, it can prevent unwanted beneficiaries from owning business interests.
- It can provide the necessary funds to pay debts associated with the business, expenses, and taxes.

86. For cross purchase stock agreements in which there are multiple shareholders, an escrow arrangement holding policies on each shareholder can be used to avoid multiple policies.

87. IRC §83.

- For current employees, the agreement can provide a mechanism to buy into the business along with the necessary funds to accomplish the buy-in.
- It can play a significant role in ensuring that the business continues in the hands of suitable persons and assures continuity for customers, creditors, and employees.

On the downside, a hybrid or redemption type of buy-sell agreement may not yield favorable tax consequences upon the purchase of business interests in accordance with the agreement. This is typically not a problem with a cross-purchase agreement. The basic problem is that a corporate distribution in a redemption of stock is taxed as a dividend (i.e., taxed as ordinary income to the extent of earnings and profits, without recovery of basis), unless it meets the technical requirements of IRC §§302(b) or 303.

Obviously, the parties to the agreement must have funds available to buy the stock at the time the agreement is triggered. Typically, life insurance is purchased for each business owner to cover the total purchase price (or at least the down payment). However, the premiums on such policies are not deductible[88] and can create a substantial ongoing expense.

The purchase of a deceased shareholder's stock can deprive the estate of the advantage of certain post-mortem estate planning techniques such as special-use valuation and installment payment of federal estate tax.

Note. As for the installment sale provision, the sale of all or a substantial part of the shares during the deferral period accelerates the deferred taxes.[89] Thus, it may be a good strategy to plan a series of redemptions or purchases in amounts equal to the taxes that must be paid in each of the 15 years of the federal estate tax deferral period available under IRC §6166.

If a buy-sell agreement is not planned well, the agreement can prevent a gift of stock to a trust for the surviving spouse from qualifying for the estate tax marital deduction. In *Estate of Rinaldi v. U.S.*,[90] a purchase option was created in the decedent's will for a son that was named as trustee of a QTIP trust for the decedent's surviving spouse. The court determined that the marital deduction was not available because the son could purchase the stock at book value by ceasing active management in the company. The result would have been the same had the option been included in an independent buy-sell agreement.

FUNDING

As indicated above, life insurance is often the preferred means of funding the testamentary purchases of stock under a buy-sell agreement because the death benefit is financed by a series of smaller premium payments and because the proceeds are received by the beneficiary without income tax liability.[91] However, there can be traps associated with life insurance funding.

- Proceeds received by a C corporation can increase the corporation's AMT liability by increasing its adjusted current earnings even if the proceeds are used to redeem the stockholder's shares.[92]
- Policies in which the corporation is both the owner and the beneficiary must comply with the notice and consent requirements of IRC §101(j)(4).[93]

---

88. See IRC §264.
89. IRC §6166 (g)(1)(B).
90. *Estate of Rinaldi v. U.S.*, 38 Fed. Cl. 341 (1997), *aff'd* 178 F.3d 1308 (Fed. Cir. 1998), *cert. denied* (1999).
91. See IRC §101.
92. See IRC §56(g).
93. IRC §101(j)(4).

Additionally, life insurance may be sufficient to fund the buyout of a deceased owner's interest but may be insufficient to fund the lifetime redemption occasioned by the owner's disability or retirement.

Observation. The cash value of a permanent life insurance policy may be withdrawn by loan or surrender of the policy, but the value may be a very small percentage of the death benefit and therefore inadequate to finance the buy-out. Disability insurance may be used to finance a purchase occasioned by an owner's disability, but it can be quite expensive. It cannot be applied toward the purchase of a retiring owner's interest or used to prevent the sale of an interest in the business to a buyer outside the family unit.

It is possible to use accumulated earnings of the business to fund a redemption. However, such a strategy may not be treated as a "reasonable need of the business," with the result that the business (if it is a C corporation) can be subject to the accumulated earnings tax.[94]

94. IRC §531. However, corporate accumulations used to pay off a note given to a stockholder for a redemption is a reasonable need of the business as a debt retirement cost. But see *Smoot Sand & Gravel Corp. v. Comm'r,* 274 F.2d 495 (4th Cir. 1960), *cert. denied,* 362 U.S. 976 (1960).