CHAPTER 71

Estate Planning, Business Succession Planning, and Exit Planning – How Can (or Do) They Fit Together?

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INTRODUCTION

Previous chapters of this book have explained various concepts and techniques used in estate planning. When a closely held business is involved, there are many more issues that need to be addressed. Often times, the closely held business comprises approximately 80% of a family's wealth, and unless sold, is also a relatively illiquid asset. Typical forms of ownership of family-owned businesses are the S Corporation, C Corporation, LLC, and limited partnership. The design and implementation of any estate plan in which a closely held business is a major asset must, by necessity, focus on the succession plan of the business and/or the exit of the owner(s) from the business. Sometimes they are mutually exclusive, sometimes they overlap.

The succession plan focuses on who will run your company, either upon your retirement or upon your death. In other words, this is a management issue. If your spouse and children are already in the business, the succession plan will address how the company will continue to run. If your family does not want to (or cannot) continue to run the business upon your death or retirement, but nevertheless desires to keep the business in the family, then the succession plan must address the location, hiring, and retention of a quality management team.

The exit plan concerns the owner's sale of the business, either during life or upon death. The potential buyers of the family members typically fall into three groups:

- The owner's children
- Key employees
- Third-party buyer

Complicating any such sale is the fact that the closely held business is by its very nature, a non-public company, not easily valued. There is typically no ready market for the business.

THE TECHNIQUES

A common thread running through most estate plans involving a closely held business is, how can we retain control of the business and enjoy the benefits of ownership (that is "cash flow") yet remove some or all of the business from our estate? The solution is the sophisticated use of trusts and integrating and layering multiple planning solutions.

EXAMPLE 1

Family business is owned 100% by one or both parents. The goal is to transfer the business to future generations, provide creditor and/or divorce protection for children and grandchildren, retain cash flow from the business, and control management of business for at least the next few years, while excluding all future appreciation of the business from the parents' estates. The combined family estate exceeds the estate tax exemption amounts.

If the business is owned by a C Corporation, then make the S corporation election. This is important for pass through tax treatment.

If there is only voting stock outstanding, the next step is to recapitalize the corporation so there is voting and non-voting common stock. This will not violate the S corporation rules as long as there is only one class of stock (that is, common stock).

Establish an irrevocable trust. With careful drafting, this irrevocable trust will be "invisible" for income tax purposes yet be respected as a legal person separate and distinct from the grantor or its beneficiaries. This is what is known to estate planners as an intentionally defective grantor trust. The intentionally defective grantor trust is a valid S Corporation shareholder (note — only certain types of trusts are permitted shareholders, otherwise the S election becomes void).

Because this trust is also designed to benefit children and multiple future generations, it is also sometimes referred to as a "dynasty trust." Again, careful drafting is essential to ensure the trust is insulated from the application of the generation-skipping transfer tax.

Finally, some or all of the non-voting stock is gifted and/or sold to the trust. If the stock is sold to the trust, usually it will be for an interest only "balloon" promissory note or in exchange for a self-canceling installment note. Because the trust is a defective grantor trust, the owner will not pay income tax on the sale. Because the grantor is retaining ownership of the voting stock, the owner maintains control.

The annual earnings from the S Corporation attributable to the stock owned by the trust will flow to the trust. Because the trust is a grantor trust, the grantor will be responsible for tax on the earnings, even though the distributions are made directly to the trust (because it is the true shareholder). The tax payments on those earnings are, in effect, a non-taxable gift to the trust. The cash received by the trust is used to pay interest to the grantor and make any principal distributions, if desired. The trust can also purchase life insurance on one or both of the parents using the cash received from S corporation shares.

On death of the grantor, only the value of the unpaid promissory note is included in the grantor's estate. Any appreciation in the S corporation's stock value will be outside the grantor's estate, not included in the estates of the children and grandchildren, and exempt from generation-skipping transfer taxes. Further leverage is achieved through an expert appraisal of the business before transferring it into the trust. The non-voting stock will be subject to a discount, which will further enhance the estate and generation-skipping transfer tax savings.

EXAMPLE 2

Assume the same facts as above, except instead of selling shares to an intentionally defective grantor trust, the parents establish a Grantor Retained Annuity Trust (GRAT) which will hold the non-voting S corporation stock. The length of the GRAT will be determined by how much annual cash flow is desired by the parents and by the published IRS interest rate for the GRAT calculation. At the end of the GRAT term, the S corporation stock is then distributed from the GRAT into an irrevocable dynasty trust for the benefit of children and future generations with no gift tax consequences (assuming the GRAT was "zeroed-out" at inception).

EXAMPLE 3

Assume the same facts as above, except the "exit" strategy is to seek a buyer of the business. In working with consultants, the family has determined a three-year time horizon is realistic.

Since the actual sales price three years from now is, in all likelihood, greater than the value today, the GRAT is an ideal technique to push substantial value out of the parents' estates and into a dynasty trust similar to the previous examples. Today's value is established by an expert appraisal before contributing shares to the GRAT. The annuity from the GRAT remains the same whether the stock sale occurs inside the GRAT or after the GRAT terminates, in which case the sale is made by the dynasty trust.

This is a powerful technique in almost any situation where there is a vision of selling some or all of the family business, or where a public offering is planned. Since the time frame for any public offering of closely held stock is usually several months, placing some or all of the stock to be sold into a GRAT can achieve substantial estate and gift tax savings, while permitting the parents to retain a substantial portion of the profit from the sale of their business.

EXAMPLE 4

Often in very large estates, life insurance is a critical component to provide funding for future estate tax liability. However, the larger the potential estate tax, the larger the premium. The larger the premium, the more likely the annual premiums will exceed the "Crummey" gift exclusions. Once the annual Crummey gift exclusions are used, the life insurance premiums will begin to erode the lifetime gift exclusion of $1 million. Then, the issue becomes, how do we get the funds for premium payments into the trust without incurring additional gift taxes once the lifetime exclusion is used up? One solution is as follows.

All future gifts into the trust that exceed the lifetime exemption (and annual Crummey exclusion) will be treated as "loans" from the grantor. The loans must carry the prescribed IRS interest rate. This interest can be paid annually or accrued. A GRAT is then established with potentially highly appreciating assets such as real estate, closely held business stock, low basis investments, or similar assets. At the end of the GRAT term, the assets inside the GRAT are distributed to the life insurance trust free of gift taxes. The life insurance trust then repays the loans plus any accrued interest.

This same technique can be used to repay loans made by third party lenders. There are some institutions that will lend the life insurance trust money to pay insurance premiums. In this manner, an unrelated financial institution can provide the funding so the grantor/insured doesn't have to lend money to his or her insurance trust.

SUMMARY

The foundation for any of the foregoing applications is the skillfully drafted irrevocable trust, one or more GRATs, perhaps an FLP, and an attorney specializing in estate planning. This is not "form book" planning since it requires mastery of several different techniques and the ability to determine which techniques can be integrated with others.

Daniel B Capobianco specializes in domestic and international taxation with emphasis on complex integrated estate plans with multiple tax strategies, charitable planning, and business succession planning.