St. Louis Estate Planning Council Speaker Series
Business Succession: Tips, Traps, and Common Mistakes in Estate Planning for Business Owners©

By: Ann B. Burns and Justin W. Whitney, Lathrop GPM LLP

These seminar materials are intended to provide the seminar participants with guidance in estate planning matters. The materials do not constitute, and should not be treated as legal advice regarding the use of any particular estate planning technique or the tax consequences associated with any technique. Every effort has been made to assure the accuracy of these materials. Lathrop GPM LLP and the authors do not assume responsibility for any individual's reliance upon the written or oral information provided during the seminar. Seminar participants should independently verify all statements made before applying them to a particular fact situation, and should independently determine the tax and non-tax consequences of any particular estate planning technique before recommending the technique to a client or implementing it on the client's behalf.

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I. Identifying the Owner's Goals and Objectives and Assembling the Team of Advisors

A. Focus on the Ultimate Outcome. The starting point in a successful business succession plan is to identify the business owner's goals and objectives. What do they want as the ultimate outcome of the plan?

B. Common Objectives. Common objectives before business owners include some or all of the following:

1. Lump-sum cash payout.
2. Income stream.
3. Diversification of investments.
4. Continued investment in business/rollover equity.
5. Pass the business to next generation of family.
6. Continued viability of the business.
7. Protecting employees' jobs and security.
8. Benefiting the community or charity.
9. Fair treatment of family members – balancing the interests of those receiving the business and those receiving other assets.

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Business Succession "Big Picture" Planning Points			
Goals and Objectives	Family	Charity	Third Party
Mechanics of Transfer	Lifetime gift, sale, testamentary bequest or combination of all three?	Lifetime gift or testamentary bequest? Public charity, private foundation or supporting organization.	Terms of sale, financing, asset purchase or stock sale?
Management and Talent Assessment	Is the next generation interested and capable? Will family be active or passive owners? What is role of and relationship to non-family management?	What is the impact on current employees and customers?	Identify, train, develop management team to maximize value on sale. Consider organizational chart before and after sale. Having a management succession plan increases intrinsic value.
Communication	Will personality traits within the family disrupt the business? What is the perceived fairness among family? Consider use of family council.	What does the charity plan to do with the business? Avoid characterization of prearranged sale.	Does management embrace the change? Consider job security for employees.
Corporate Documents	Who has the voting control? How and when will control change to next generation? Is the next generation ready for control?	How will the business be run during ownership by charity?	What transfer restrictions exist? Does the sale trigger buy/sell consequences or due on sale clause under loan documents? Is corporate hygiene up to date?
Estate Planning	Should next generation own stock personally or through an irrevocable trust? Who will serve as Trustee? Does change in Trustee result in change in voting control?	Charitable gift annuity, charitable lead trust or charitable remainder trust?	Consider gifting stock in advance of sale to benefit from valuation discounts applicable to operating business.

Business Succession "Big Picture" Planning Points			
Goals and Objectives	Family	Charity	Third Party
Financial Considerations	Does owner need sale proceeds or income from business to retire? What are the owner's other assets? Consider retaining income stream through preferred dividends or seller financing.	Does owner have taxable income or taxable estate to benefit from charitable deduction?	Consider consultation with industry specific valuation expert to arrive at optimum metrics for sale price and terms. Does owner have an ongoing indemnity obligation to buyer? Will owner serve as consultant under consulting agreement?
Tax Planning	Consider choice of entity for optimal income taxation. Consider income tax effect of sale or retained income interest. Liquidity to pay estate taxes.	Income tax deduction for lifetime gift and estate tax deduction for charitable bequest.	Consult with accountant on allocation of purchase price to asset classes to optimize capital gain treatment and depreciation recapture.
Valuation	If gifting or selling shares to family, consider maximizing use of lack of marketability and minority interest discounts.	Deduction for charitable gift will require meeting requirements of qualified appraisal.	Consider valuation based on sales and financial data with less emphasis on lack of marketability and control discounts.

C. Working with the Team of Advisors. A successful estate and business succession plan requires that the attorney work with the other professional advisors surrounding the owner and the business to assess the owner’s objectives, determine the financial and tax consequences of the plan, and assure that the details of the plan are implemented completely and timely. The team of advisors may include the following:

1. Certified public accountant and other tax professionals. These advisors should be engaged early and throughout the process to ensure the succession plan is implemented in the most tax efficient manner, not only for the owner, but for the

business and ideally, for the subsequent owners and family members. The tax planning should take into consideration income, estate, and gift taxes. Engaging the tax advisor early to assist with issues like choice of entity, allocating purchase price among asset classes, choosing between an asset sale and a stock sale and planning for valuation discounts is critical.

- **Practice Pointer**. A tax strategy that can be very beneficial to the owner can cause adverse tax consequences to other owners or trusts for other family members. Always be cognizant of who is your client and who is not. Dual representation of all family members involved in the succession planning may not be possible when actual or potential conflicts of interests are present.

- **Practice Pointer**. If the business assets are being sold rather than the entity, the manner in which purchase price is allocated among asset classes can make a significant difference in the income taxes arising from the sale. Thought should be given to how the purchase price will be allocated early in the negotiation stages. Value allocated to assets subject to depreciation recapture will be taxed at ordinary income rates whereas as goodwill will be taxed at capital gain rates. Involving a tax professional early in the negotiation process can help to optimize the income tax result of the sale.

2. Financial and Investment Advisors. The financial advisor can provide the "big picture" of all of the owner's assets and wealth including the business itself and non-business assets. A well-informed owner will have considered where they stand financially so that their financial needs in retirement can be factored into the succession plan. The attorney should not assume that the owner has completely thought through their retirement planning and should be advised to do so as part of the overall succession planning. Financial advisors can analyze the owner's assets separate from the business and whether those assets will provide sufficient cash flow and liquidity to maintain the owner's lifestyle throughout retirement. A financial advisor can provide a *Monte Carlo*

analysis to forecast the owner's cash flow in retirement based on varying investment scenarios.

3. Lenders. Most businesses will have an extensive credit facility of promissory notes, security agreements, mortgages and loan agreements. These documents may have provisions that trigger a borrower default under circumstances common to a succession plan like a change in ownership of the business or sale of substantially all of the businesses assets. Accordingly, involving the lender in initial discussions and obtaining advance consent for any transactions that might otherwise result in a default under the loan documents is important.

- **Practice Pointer**. An owner may be surprised to find out that the business loan documents may provide that their own death constitutes a default authorizing the lender to accelerate the loan making the entire balance due immediately. An owner's estate may be required to provide a substitute guarantee in order to keep the loan in place.

4. Appraisers and Valuation Professionals. Often times an owner may be in the best position to know the value of the business and reluctant to hire a professional appraiser. Even if the owner is well-versed in the value of the business, if the succession plan involves a gift or sale to a related party a qualified appraiser should be retained to calculate applicable discounts for lack of control and lack of marketability and issue a valuation report that satisfies the adequate disclosure requirements to ensure that statutes of limitations will start running against the IRS with respect to challenging the value of any reported gift.

- **Practice Pointer**. Some industries use a common metric to measure the value of a business. Examples include a multiplier of annual revenue, a multi-year average of historical earnings, discounted future cash flows, book value or comparable sales. An accountant who specializes in business valuation or an investment banker can provide industry regional or national data on what businesses are selling for.

Even if the owner is confident of the value of their business or has a certain offer on the table, a consultation with a valuation professional can help the owner be confident they are realizing the full value of the business.

- **Practice Pointer**. A valuation professional can identify areas that may cause a potential buyer to discount the value of the business. Addressing these issues early might result in a higher sale price. For example, establishing a management team that can operate the business effectively with minimal involvement from the owner will increase the value from a buyer's perspective. On the other hand, if the owner is a key person whose presence day to day is critical to the success of the business, the value is likely to be discounted.

5. Insurance Professionals. Where the business succession plan includes insurance needs for income continuity, business stability, or the payment of estate taxes, insurance professionals should be consulted to determine the appropriate level and type of insurance products that might be needed.

6. Family Business Consultant. In family businesses, whether all, some or none of the members of the next generation will be involved in the business, family business consultants can be vital to assuring long-term stability in the business and the family. A business consultant can help with structure and governance issues that are critical to the future success of the business.

- **Practice Pointer**. Consider increasing the presence of neutral management with the business. Doing so can increase the value of the business to third party purchasers or increase the likelihood of a successful transition to the next generation. Diversifying the management of the company with neutral professionals outside of the immediate family prior to a change in ownership can help to ensure business continuity. This can be accomplished by adding outsiders with business experience to the board of directors or by hiring business consultants who work with the business on a continuing basis and can be a resource to the new ownership. Use of outside management may be reassuring to the employees that the business can thrive after the change in ownership.

- **Practice Pointer**. In situations where some family members are active in managing the business and other family members are passive, consider including a provision in the entity documents requiring an outside industry consultant to review compensation of management to ensure reasonableness. Also consider the use of a "family council" comprised of family members who meet regularly to discuss the family's role in business operations without the involvement of non-family management.

D. Assessing the Situation. The tools available to an estate and business planner are varied and must be selected carefully. Developing the strategy of a business plan requires a careful assessment of the entire situation:

1. What are the owner's objectives?
   a. Which objectives conflict with one another?
   b. How might they be reconciled?
   c. Can the owner prioritize conflicting objectives?
2. What is the owner's tolerance for complexity?
   a. Will the owner or the owner's staff be able to honor the formalities of the recommended planning tools?
   b. If not, is the owner willing to turn over responsibility for technical compliance to a reliable third party?
3. Does the owner want to retain control?
   a. Is legal control required or is family control sufficient?
   b. Is a voting trust appropriate?
4. What are the family circumstances?
   a. Is it a second marriage?
   b. Are all the children involved in the business?
   c. Do any family members have special needs?

- **Practice Pointer**. Always ask yourself "who is my client?" Consider at the beginning of the engagement what information may become relevant to the parties involved in the planning and the consequences of disclosing or not disclosing that information. Consider whether each party to a transaction should have separate counsel.

- **Practice Pointer**. Consider at every step of the process what communication is needed. Rarely is too much communication a problem. Too little can create problems that could have been avoided.

5. Does the owner allow clear and free-flowing conversation among the advisors?

    a. Will the owner consent to include other family members in the planning conversation?

    b. Is the owner willing to communicate the plan to the family?

6. What corporate documents are currently in place?

    a. Are there transfer restrictions on the business interests?

    b. Who are the other owners? What are their objectives?

7. What is the debt structure of the business and the owner?

    a. Has the owner provided personal guarantees or pledged assets?

    b. Is the lender willing to consent to transfers of business interests?

8. Where is the business in its life cycle?

    a. Is it financially healthy?

    b. Is it growing?

    c. What is the owner's basis?

9. If trusts will be utilized, what are the fiduciary options?

   a. Family members?

   b. Business associates?

   c. Corporate fiduciaries?

- **Practice Pointer**. Some corporate Trustees are not well-equipped to handle the day-to-day operations of an active business; others have talented Special Assets Groups that are able to manage an operating business. If a Trust will have a continuing ownership interest in an active family business, naming a family member, business associate or corporate Trustee with an understanding and interest in the business is advisable.

Owner’s Primary Goal: Benefit the Community

Planning Tools:

Transfer stock to charity through gifting, testamentary bequest or through charitable gift annuity, charitable lead trust or charitable remainder trust.

Practical Considerations:

- Owner can choose to benefit a public charity, supporting organization or private foundation.
- The extent to which the owner anticipates needing an income stream may influence the choice between an outright charitable gift and a split interest charitable gift.

Legal Considerations:

- IRS may characterize gift of stock to charity as a pre-arranged sale if it is a practical certainty that the business will redeem the stock following the gift. If the gift is a pre-arranged sale, the owner must recognize any built-in gain on the stock.
- A redemption of the gifted stock will increase the percentage of the business owned by other shareholders such as G2.

Tax Considerations:

- Owner will receive a charitable deduction for income tax purposes for the fair market value of stock gifted to a charity and avoid recognition of any built-in gain on the stock.
- Owner will receive an income tax charitable deduction to the extent gifted stock exceeds the value of the charitable annuity interest and postpone and possibly avoid built in gain on stock contributed to the charity.
- Owner will receive an income tax charitable deduction equal to the present value of the remainder interest in a charitable remainder trust and postpone and possibly avoid built in gain on stock contributed to the charitable remainder trust.
- Owner will receive an income tax charitable deduction for the value of a charitable lead interest in a grantor charitable lead trust but owner will be taxed on the income. No income tax deduction is available for a non-grantor charitable lead trust.
- Owner will receive an estate tax charitable deduction for the fair market value of stock bequeathed to a charity.
- Does owner have sufficient taxable income to fully utilize the charitable deductions resulting from a charitable gift?

Valuation Considerations:

- The fair market value of stock gifted or bequeathed will determine the income and estate tax deductions available.

Financial Considerations:

- Owner can retain an income stream by contributing stock to a charitable gift annuity or charitable remainder trust.
- Owner should consider whether the annuity payments in combination with other sources of income will be sufficient to meet their financial needs.

Owner's Primary Goal: Cash Payout or Income Stream
Planning Tools: Sell stock to third party at fair market value in arms-length transaction or recapitalize to provide owner with preferred stock with guaranteed dividend.
Practical Considerations: • Owner can maximize value of business by having management succession plan in place in advance of sale. • Consider structuring sale as an asset sale or a stock sale. • Consider whether the owner will take any rollover equity with the purchaser. • Will the sale be for cash or financed with a promissory note? If the sale is paid through a note consider the creditworthiness of the buyer and secure the note with a security interest in the stock or other assets. • Will the new ownership retain the current employees and provide comparable benefits?
Legal Considerations: • Does the sale require advance approval from a lender or regulator? • Do the operating agreement or bylaws provide for rights of first refusal in other parties before the stock can be sold? • Consider warranties that owner is making under sale documents as to condition of assets, representations about finances, etc.
Tax Considerations: • Owner may gift the stock to children or an irrevocable trust at a discounted value if the transfer is sufficiently in advance of any sale plans. • Consider how the purchase price will be allocated among asset classes so as to minimize taxation at ordinary income rates. • Owner may be taxed at capital gain rates and ordinary income tax rates for gain on sale. • Consider deferring gain recognition through installment sale.
Valuation Considerations: • Consider consulting with a valuation expert regarding how much comparable businesses are selling for and the financial metrics used to arrive at the sale price.
Financial Considerations: • Owner should consult with financial advisor regarding whether amount realized from sale and owner's other assets will be sufficient for financial needs. • Owner may be able to retain employment following sale through consulting agreement with buyer.

Owner's Primary Goal: Business Continuity for Next Generation
Planning Tool: Transfer of stock to children through gift, sale or inheritance.
Practical Considerations: When is the owner comfortable handing over control of the business? • If immediately: Consider gifting shares to G2 and/or selling shares in exchange for a promissory note. • If in future: Consider testamentary bequest of shares and consider whether to use equalizing gifts for other children.
Legal Considerations: • Will child benefit from owning stock in an irrevocable trust protected from creditors and excluded from child's gross estate? • If yes, consider preparing irrevocable trust created by owner for benefit of child. Child can serve as Trustee and exercising voting control over stock. Trust can receive gift of stock or purchase the stock through sale. • If no, consider gifting stock outright to child or child's revocable trust.
Tax Considerations: • Transferring stock to G2 shifts future appreciation in stock out of owner's estate. • If stock is held in a GST exempt dynasty trust value of business can be removed from transfer tax system. • Owner will be taxed on income from stock held in grantor trust for G2. • Stock sold to grantor trust will not result in capital gain to owner for income tax purposes. • Consider transferring stock to GRAT.
Valuation Considerations: • Consider use of lack of control and lack of marketability discounts to maximize leverage of gift, estate, and generation skipping transfer tax exemption.
Financial Considerations: • Owner can retain income stream from interest and principal payments from promissory note for sale of stock. • Owner could exchange stock for preferred stock with a fixed dividend to provide income. • Will Owner have sufficient liquidity to pay estate tax if stock is gifted or bequeathed to children.

II. Coordinating the Business Succession Plan with the Business Owner's Estate Plan.

A. Reviewing the Owner's Estate Plan. A succession plan and the business owner's estate plan are important pieces of the business transition process. The business succession plan is designed to transfer ownership and management of the business, while the business owner's estate plan creates the structure and mechanism for transferring those assets along with any non-business assets. In addition, the estate plan helps address equalization between beneficiaries, direct what will happen to the business ownership at death, provide liquidity planning for payment of taxes and other items, and the transition of the management of the company.

1. Base Estate Planning Documents. On a basic level, every business owner's estate plan should contain a testamentary instrument, either a will or revocable trust, a power of attorney for transition during incapacity, beneficiary designations to coordinate retirement accounts and life insurance, a health care directive, insurance planning, and perhaps some more specialized techniques to take advantage of the discounts available for business assets. It is also important to discuss with the business owner his or her overall objectives for retaining the business and, if so, for how long. If the owner intends to transition management of the business to another person, the plan will be different than those business owners who plan to sell within the next couple of years or completely liquidate the business upon death.

2. Paying for Estate Taxes. A key aspect of business owners' estate plan is planning for payment of estate taxes. Often a business owner will have relatively few liquid or non-business assets in his or her estate. The business may be quite valuable and can trigger substantial tax obligations. An estate tax return and the corresponding tax bill are due to the IRS nine months after the decedent's date of death. Even if the

return is extended, the tax is due nine months after death. There are significant penalties that may result if the tax is paid late.

3. Stock Redemption. If a business owner dies with an estate that is primarily made up of company assets, it may be difficult to find the liquid assets to pay the estate tax. There are a couple of ways to address this shortfall. One is to structure the business plan to require or allow for redemption by the company to pay cash for the deceased shareholder's stock and as a result create some liquidity. The redemption has a number of tax consequences and it is advisable that the estate planner work carefully with the business advisor to plan and structure the payment of that redemption in a way that does not affect the valuation for estate tax purposes and the estate's ability to pay the tax. Section 303 may provide for a tax-free redemption under certain circumstances.

4. Section 6166 Installment Payments. Another option is to seek relief under IRC § 6166 to extend the time in which to pay estate taxes. This is the IRS's version of an installment loan to defer the tax for a period of time for those decedents with a certain proportion of closely-held business interests as an overall percentage of their estates. Interest is charged on this installment loan, but it is lower than the annual federal rate. It is possible to elect to defer the portion of overall estate tax attributable to that closely-held business interest. IRC § 6166(a)(2). The application of IRC § 6166 can be complex, and there are several requirements to qualify for tax deferral under this section:

a. More than 35 percent of the adjusted gross estate must consist of a closely-held business interest. IRC § 6166(a)(1). In this particular requirement, a residential property on a farm can be considered as part of a closely-held business as long as the owner, lessee, or farm's employees occupy the real estate for the purposes of operating or maintaining the farm. IRC § 6166(b)(3).

b. The business interests must be an active trade or business carried on as a proprietorship, partnership, or corporation. IRC § 6166(b)(1). As a result, this active business requirement eliminates those business entities that exist simply as a vehicle for asset management or holding company.

c. The business must be closely-held, meaning that it must be: (a) A proprietorship in which the decedent held 100 percent ownership interest, or (b) A partnership that has 15 or fewer shareholders or partners, or (c) A corporation that has 15 or fewer shareholders or partners.

d. The gross estate must include 20 percent or more of the corporation's voting stock or 20 percent or more of the partnership's capital interest. IRC § 6166(b)(1)(B)(i) and (C)(i). If the interest or stock is not readily tradable, the estate administrator may elect to treat all of that interest or stock that is attributable to the decedent as included in the gross estate. IRC § 6166(b)(7). The estate, however, will not receive the benefit of the initial lower interest rate and must begin the installment payments nine months after the decedent's date of death. Stock is considered not readily tradable if the fiduciary cannot sell it on the stock exchange or over the counter market. IRC § 6166(b)(7)(B).

B. Specific Family Situations. Another common aspect of many business owners' estate plans is planning for second marriages or equalization among children or descendants who may or may not be actively involved in the management of the business. The testamentary instrument, the will or revocable trust, can account for all of these issues and can work to smooth the transition of an operating business.

1. Second Marriage. In a second marriage situation, it is common to recommend a marital trust at the first spouse's death. This marital trust can be structured such that the surviving spouse retains an income stream from the company by way of mandatory income distributions from the trust, but the decedent actually controls where the principal of the trust passes on the surviving spouse's death.

2. Marital Trust. For example, an operating business or stock can be transferred into the trust, the surviving spouse retains the distributions related to that stock as income distributions from the trust, but the children of the decedent receive the stock outright in equal shares upon the surviving spouse's death. It is important in this case, and in most cases, to carefully select the fiduciary or trustee that will be in charge of this trust. The fiduciary's responsibility to vote or operate the business may be at odds with the fiduciary's management of the trust for the benefit of the surviving spouse. Careful drafting should clarify the conflicting obligations of the trustee, the interests of the beneficiaries and the objectives for the business. The documents should also specifically allow or direct retention of the business assets and waive the duty to diversify.

3. Not All Children Active in Business. Another common problem is that the client may have many children, but only a few or just one may be involved in the active operation of the business. This one child might be the business successor in that the owner hopes to have him or her own and operate the business after the owner's death. It can be difficult to equalize the benefits passing to all of the children if that is the desired result. There are a couple of options for accomplishing this, namely by using trusts, non-business distributions at death, lifetime gifts and life insurance. It is also possible to use some of the vehicles discussed below to transfer some of the economic benefits of the business assets, without passing control or power over the management of the business.

On the other hand, the owner may be satisfied with the child taking over the business receiving a larger inheritance than the other children and not care for making equalizing provisions. For example, if one child committed their life to staying close to home to continue the family business and the other children moved away to pursue their own opportunities, the owner may feel that it is equitable that the child continuing the business may receive a larger inheritance than the rest. Supporting that view is the idea that the inheritance of the business is akin to a reward of equity in the business as compensation for the child's involvement. Consideration should be given to discussing the estate plan with the children so that they can understand the reasoning behind any unequal distributions that might result. Conversations in that regard may prevent hurt feelings and arguing among siblings in the future.

- **Practice Pointer.** A family meeting to explain the estate plan to all family members can go a long way to providing family harmony and assuring continuity for the family. The best practice is to include in the meeting all the key professionals involved. The tax, financial, business and legal advisors each bring unique and valuable skills to a family meeting.

4. Equalizing Distributions Among Children. Typically, at the death of the surviving spouse, the remaining assets held in a trust after payment of expenses will be divided into shares for the children. Consider a family with two children, Child A is involved in the business and Child B is not involved.

a. Option 1. Specific bequest of the business to Child A with bequest of an equal amount to Child B. The remaining trust estate is divided equally among Child A and Child B. This option could work well where the value of the business is small in relation to the remaining trust estate and there is sufficient liquidity to provide for the equalizing bequest to Child B. From a drafting perspective it may be easiest to specify that the equalizing bequest will be determined based on an appraisal of the business given that the value of the business will change from year to year. Note, however, that satisfying a pecuniary bequest can cause recognition of capital gains, if the stock appreciates from the date of death to the date of funding.

b. Option 2. Divide the trust estate into equal shares and direct the Trustee to allocate the business to Child A and other assets to Child B. If the appraised value of the business exceeds Child A's share, one drafting option is to provide that the size of Child A's share will be increased to account for the increased value with a corresponding reduction in the value of Child B's share. A second option is to provide that Child A has a right of first refusal to purchase the value in excess of their share from the Trustee. The terms under which Child A purchases the excess value could be: (i) an amortizing promissory note with interest; (ii) installment payments; or (iii) Child A is required to obtain financing.

c. Option 3. Divide the trust estate into equal shares and provide Child A with a right of first refusal to purchase the business from the trust estate. The terms under which Child A may purchase the business are similar to those under Option 2. The drafter of the trust will need to consider Child A's ability to obtaining financing for the purchase against the burden that Child B would assume if a large portion of Child B's inheritance will be in the form of a promissory note from Child A.

C. Life Insurance. Life insurance is also an important component to the business owner's estate plan. Insurance can be used to balance out and equalize gifts to children that are not participating in the business, or spouses, and also can be used to create the liquidity necessary to pay estate taxes. The most tax efficient way to purchase large amounts of insurance, while not adding to the taxable estate, is to create an irrevocable life insurance trust.

D. Planning for Replacement of Income. Providing an adequate income to the business owner and his or her spouse is typically an important goal of business succession planning. While the owner is working full time in the business, he or she has the opportunity to draw income out through salary and benefits. In addition, the owner receives the dividends or distributions from the business that are attributable to his or her ownership interest. When the entrepreneur begins to think about cutting back on the amount of time spent working in the business or about reducing his or her ownership in the business, one of the first concerns is how to replace that reduced income stream. If the owner cuts back his or her working hours at the business, typically there is some reduction in compensation taken to meet the requirements of IRC § 162 for reasonable compensation. If the owner transfers a portion of his or her ownership interest by gift or sale, the distributions attributable to those ownership interests will pass to the transferees and not the previous owner. Summarized below are a few options to allow for the owner to transition ownership of the business to the next generation while still retaining income:

1. Option 1. The business is recapitalized with the owner exchanging common stock in exchange for a preferred equity interest that pays a stated divided.

2. Option 2. The business redeems a portion of the owner's equity interest in exchange for a promissory note with principal and interest payments amortized in a manner to meet the owner's cash flow needs.

3. Option 3. The business owner sells some or all of their equity interest to a child in exchange for a promissory note with annual interest only payments and a balloon payment due at maturity. The promissory note can allow for early payment of principal without penalty. If the interest payments are insufficient to meet the owner's living expenses, the child can make an early repayment of principal to help the owner's cash flow.

All of the options would have income tax consequences to the seller owner, often causing recognition of capital gains or recapture of depreciation taxes as ordinary income. This demonstrates the classic problem of competing objectives: passing on the business, maintaining cash flow and minimizing taxes. Sometimes, it is not possible to have it all.

E. Specialized Business Asset Estate Planning Vehicles. In addition to addressing common problems such as retaining an income stream for the widow or widower and equalizing the distributions to children through basic estate planning, there are some specialized techniques that work particularly well with closely-held business interests. Many of these options are lifetime tools and are especially effective for those business owners who may be expecting a large liquidity event or sale of their business interest. Exhibits A and B contain summaries of two common techniques: a grantor retained annuity trust (GRAT) and an installment sale to an intentionally defective grantor trust (IDGT).

It is important to realize that a number of great estate tax savings tools are also great business succession planning tools. Using either a grantor retained annuity trust (GRAT) or an installment sale to a grantor trust (IDGT) or possibly both, the entrepreneur can transfer significant portions of the business at reduced or fixed values and still receive GRAT annuity payments or payments on a promissory note. If the business cash flows well, it can distribute sufficient income to the trust to make the annuity or note payments to the owner. These payments can provide the owner with a reliable cash flow. The technique may also shift value to the trust and its beneficiaries.

1. GRAT. A Grantor Retained Annuity Trust can provide for the appreciation from an asset, over the applicable federal rate, to pass to the next generation. The upside of GRATs is to transfer appreciation without payment of gift taxes. The restrictions are that the technique is not ideal for generation-skipping transfers and requires an appraisal of a closely-held entity each year. If the annual appraisal is not an impediment, a series of GRATs can transfer business interests to the next generation in a tax effective manner.

2. IDGT. An installment sale to a grantor trust for the children also can shift value while providing cash flow to the entrepreneur. By contrast to a gift, which might be made to all of the children, an installment sale is generally made only to the children who are active in the business. The non-active children generally have no interest in paying for the business while the active children generally want an equity interest. In many family businesses, there is a tension between the active and non-active children. Non-active children may view the active children as “plunderers” who can pull value out of the business via compensation, benefits, and company-paid trips and entertainment. Active children may view the non-active children as “loafers” who do not appreciate the sacrifice the active children make and who simply wait for the benefits of the business to be bestowed upon them. An installment sale to active children can be viewed as “fairer” to the non-active children than a gift might be. Assuming the active children buy at fair market value, the family interests may be viewed as equitable.

The owner sells a portion of the business to a grantor trust for the benefit of the active children and takes back a promissory note at a rate that equals or exceeds the applicable federal rate ("AFR") to avoid an imputed gift. The children's trust makes the note payments from entity distributions and the owner receives note payments. The owner is not taxes on the sale to the grantor trust. If instead the sale were made directly to the children, without the grantor trust, the owner would report any gain from the sale, using installment sales treatment under IRC § 453, spreading the recognition of the gain out over time. The sale effectively freezes the value of the portion sold in the owner's estate, shifting future appreciation and value to the new owners. In addition, as the note is paid and the proceeds spent, the owner's estate is reduced. The sale allows the owner to keep a stream of cash flow in the form of the note payments, to ultimately shift value to the children.

3. Recapitalization. A variation is to combine a recapitalization with an installment sale to the active children. A corporation, for example, could be capitalized into voting and non-voting common shares. The owner would sell only non-voting shares to the active children. A fair amount of the equity can be shifted, the owner can retain control and, during the term of the note, the owner has a replacement income.

F. <u>During Lifetime or at Death.</u>

Tax Considerations		
Strategy	**Lifetime**	**At Death**
Sale	Capital gain for income tax purposes on sale with possible ordinary income characterization for depreciation recapture, etc.	Terms of sale, financing, asset purchase or stock sale?
Gift/Sale to Children	$12,060,000 gift tax exemption. Consider sale to intentionally defective grantor trust ("IDGT") benefiting children in exchange for promissory note from IDGT. Gain not recognized at time of sale because IDGT is grantor trust for income tax purposes.	$12,060,000 estate tax exemption. Testamentary bequest of stock is less tax efficient than lifetime gift because appreciation in value of business until time of death is subject to estate tax.
Gift to Charity	Income and gift tax charitable deduction for fair market value of stock at date of gift.	Estate tax charitable deduction for the stock gift equal to fair market value at date of death. Risk of pre-arranged sale treatment.

III. Salary Continuation Plans, Deferred Compensation Plans, Consulting Agreements, and Non-Competes

A. <u>Salary Continuation and Deferred Compensation Plans</u>. The owner can also enter into traditional employee benefit arrangements with the business that will allow the owner to retain an income stream independent of an ownership interest. A salary continuation or deferred compensation arrangement, for example, could provide that at an anticipated retirement date the company would pay the owner a benefit for a period of years, usually five or ten years. That income would terminate before or at the owner's death so nothing would be included in the owner's estate. These deferred payments are generally not taxable to the owner until the payments are made assuming the company's obligation is unfunded and the owner has no more rights than a general creditor. Rev. Rul. 60-31, 1960-1 C.B. 174; Rev. Rul. 70-435, 1970-2 C.B. 100. The agreement must conform to the requirements of IRC § 409A. A properly drafted salary continuation or deferred compensation arrangement can provide the owner with an income stream unrelated to ownership and unrelated to current working efforts. The present value of the deferred liability is booked as an unfunded liability on the company's books, reducing the company's value. This may help in a transfer of the business to family members at a reasonable price.

- **Practice Pointer**. Recapitalizing the business and entering into a deferred compensation agreement with the owner can reduce the value of the company prior to gifting or selling non-voting shares to the active children which will transfer value to the next generation in a transfer-tax efficient manner.

B. Consulting Agreements and Non-Competes. The owner may also enter into a consulting agreement or a covenant not to compete once the owner is ready to reduce his or her commitment or to leave the business. These cannot be sham transactions; with a non-compete, the threat to the business needs to be genuine and the compensation reasonably related to the threat. Actual services must be rendered for the consulting agreement and the amount paid must be reasonable; the owner cannot retire to play golf in Florida and try to retain normal compensation under the guise of a consulting agreement. If genuine services are rendered that are of value to the company after the owner's retirement on terms similar to those that would be agreed to with a non-owner employee, however, a consulting agreement can provide value to the retiring owner.

IV. Buy Sell Agreements

A. Purpose. A buy sell agreement is a contract between the owners of the business or between the owners of the business and the business itself that provides for the transfer of all or part of an owner's interest in the business upon certain triggering events, generally at a predetermined price. Buy sell agreements for corporations are usually separate documents named share purchase agreement, buy sell agreement, shareholder agreement, cross-purchase agreement, or redemption agreement. Buy sell agreements for entities such as LLCs or partnerships are more commonly found within other entity agreements, such as the operating agreement, member control agreement, or the partnership agreement. The main purpose of the agreement is to restrict the transfer of the business interest in certain situations to certain parties and dictate the terms of transfer when transfer is allowed. Often, the agreement will contain a blanket prohibition on transfers whether during life or at death and carve out exceptions to that prohibition.

B. Terms of Agreement. Buy sell agreements are extremely important in family businesses. They allow families to decide with whom they wish to be in business and under what conditions. A well drafted buy sell agreement can accomplish a number of objectives, including:

- Transferring business interests to subsequent generations, including grandchildren;
- Keeping a family business in the family and preventing ownership by in-laws or non-family members;
- Planning for an owner's death, disability, incapacity, retirement, divorce, or dispute with other owners;
- Dictating price and terms of payment upon the transfer of a business interest or redemption by the business and minimizing disputes between sellers and buyers relating to price;
- Establishing value of the ownership interest for gift or estate tax purposes;
- Providing for governance between multiple families and generations;
- Instilling family values such as requiring owners to have specific levels of education or outside work experience to be employed by the business;

- Providing the business with liquid assets to purchase the interests from owners or their estates upon death or disability;

- Maintaining consistent levels of ownership percentages among owners or families;

- Prohibiting or voiding transfers that would jeopardize an S election;

- Electing managers and creating family boards or family representatives as ownership interests diversify further into multiple generations;

- Providing a source of income to an owner, spouse, or heir;

- Securing favorable capital gains treatment for transfers;

- Allowing current owners to sell control of the business to interested children, while still allowing non-interested children to share in the business proceeds over time;

- Benefiting a deceased owner's estate by having a ready buyer for its otherwise unmarketable assets, providing cash to pay taxes, and avoiding a negotiation over the terms of the sale;

- Taking the emotions and feelings of loyalty out of the sale or transfer process; and

- Resolving disputes or internal struggles for control.

C. Redemption Agreement. A redemption agreement, sometimes also called an entity purchase agreement, obligates or gives the option to the business itself to buy back the interest of the owner upon specific triggering events. Many agreements use a redemption approach because it is expected that the business rather than individual shareholders will have the requisite funds to make the purchase. That may or may not be a valid assumption.

If the business has purchased life insurance on each of the shareholders, for example, and the death benefit on the policy has not kept pace with the value of the shareholder's interest, the insurance proceeds at the shareholder's death may not provide adequate funds for the redemption. While this problem can be ameliorated by using the cash proceeds to the extent available and a note for the balance, the shareholder's family may have anticipated a complete buyout rather than dependency upon the future success of the business to obtain full value. Similarly, if the funding mechanism is tied to one particular trigger event (for example, death), and the trigger event that occurs is different (disability or divorce, for example), the cash may not be available at the time the company needs to make the purchase. In addition, the redemption by the company changes the proportional ownership of the shareholders. This can be problematic if, for example, one of the goals of the succession plan is to retain respective balance between two or more branches of a family.

On the other hand, redemption agreements can be particularly useful where there are a large number of owners, some of the owners are of a fairly advanced age, or of dramatically different ages and insurability, where the owners hold significantly different ownership interests, and where the original owners wish to keep the business among the initial ownership group.

D. Cross-Purchase Agreement. Under a cross-purchase agreement, the remaining owners, rather than the entity, have either the obligation or the option to purchase the transferring owner's interest. In most cases, the owners purchase on a *pro rata* basis based on their current ownership interests. The purchase is often optional among the ownership group, and proportional among those who elect to purchase. Some triggering events might be treated differently. If the goal is to maintain equality between two branches of a family, for example, shareholders directly related to that branch may have the first option to purchase before shareholders from the other branch. If divorce triggers a purchase option or obligation, it is common to allow the divorcing owner the first chance to purchase from that owner's ex-spouse so that his or her ownership interest percentage stays the same before other shareholders may purchase.

As with redemption agreements, funding is always a concern. It is common for owners to purchase life insurance policies on each other owner to fund a potential purchase. This can become fairly unworkable with larger groups of owners. For three owners, for example, six policies would be needed because each owner must own a policy on each of the other two shareholders. With four owners, however, the number of policies involved jumps to 12. As the number of shareholders grows, this solution can be expensive and unworkable. This is particularly true if there is a large discrepancy in the ages of the shareholders so that policies on older shareholders are more expensive than policies on younger shareholders. The last owner to purchase also carries the premium cost far longer than a shareholder who is bought out early.

Finally, the policies held on the lives of other shareholders can run afoul of the transfer for value rules under IRC § 101(a)(2). When a shareholder dies, his or her estate no longer has any use for the policies on the other shareholders. The remaining shareholders would normally like to purchase that insurance to help facilitate the larger purchase that will be necessary at the next death. While § 101(a)(2) allows transfers of insurance policies to various parties without subjecting the proceeds to income tax, unfortunately, a fellow shareholder does not qualify for one of those exceptions. It is sometimes necessary to establish a separate partnership to hold the insurance policies, but the partnership should have economic substance and a business purpose unrelated to the ownership of the insurance. *See*, e.g., *W. Swanson, Jr. v. Comm'r*, T. C. Memo. 1974-61, *aff'd.*, 518 7.2d 59 (8th Cir. 1975). Furthermore, the IRS will not rule on the application of the transfer for value rules to a partnership that exists primarily for the ownership of life insurance policies. *See* Rev. Proc. 2003-3, 2003-1 I.R.B. 113 (Jan. 9, 2003).

Another option is to create an owner's trust to hold policies on each shareholder, partner, or member. The trust operates similarly to a voting trust at the death of an owner. The policy proceeds are paid to the trust. The trust purchases the deceased owner's membership interests and distributes the interests pro rata to the remaining owners. One difficulty with this type of trust can be the funding of the insurance premium payments. Generally, the trust is funded by gifts or loans from the owners.

A cross-purchase agreement, however, gives the purchasing shareholder basis in the purchased assets as opposed to the redemption approach. Thus, in a C corporation, it may be preferable to use the cross-purchase approach. In addition, if the business lacks liquid assets or would not be able to borrow or to create a sinking fund to finance an entity purchase, a cross-purchase approach may be advisable.

E. Hybrid Agreements. To alleviate concerns about the appropriate form, many planners use a third type of agreement called the hybrid agreement. A hybrid agreement allows the entity or the remaining owners, or both, to buy back the transferring owner's interest. The company may be given the first right to purchase if it has sufficient funds and then, to the extent does not purchase, the remaining owners may be given the right to purchase. By contrast, the agreement may start with a cross-purchase approach, giving members of a particular family branch the first option to purchase, may next extend the option to other shareholders and, if shares are still left, may give the business a final opportunity to redeem the interest.

Hybrid agreements can structure a tiered approach of options based on the availability of life insurance proceeds, the purchasing party's ability to buy, interest in buying, anticipated tax effects of the transaction, or particular trigger event involved. The advantage of hybrid agreements is that they can provide flexibility so that the determination of the most appropriate purchasing party can be deferred until the time the decision needs to be made and more information is available.

F. Typical Trigger Events. A buy sell agreement can cover one or many trigger events. A trigger event is the predetermined event that activates or "triggers" the purchase rights under the terms of the agreement. Common trigger events are death, disability, divorce, bankruptcy, termination of employment, and sometimes, retirement. The terms of each event can vary depending upon the factual situation. Death often triggers a mandatory purchase obligation, for example, but occasionally, the parties will allow the estate to put its interest to the company or the other shareholders. A put is an option to sell at a predetermined price or under a formula that determines the price. Some parties want the legal representative of the estate to have the final authority over whether the interest must be sold. More commonly, to prevent the assets from passing to a co-owner's spouse, children or other parties, the buy sell will include a mandatory purchase obligation at an owner's death.

Similarly, purchase on disability of an owner may be either mandatory or optional. Often, the agreement will require a purchase on an owner's permanent disability with the definition of disability an important component. Sometimes the agreement will use a put option to provide liquidity and flexibility for the disabled owner instead of a mandatory sale.

Retirement is often not covered in a buy sell, but if there are non-family member owners who are employees, the agreement may provide for a purchase of the retiring non-family member's interest upon that person's retirement from employment. By contrast, family members who are owners and also are employees may retain their interest in the family business upon their retirement.

A well-drafted agreement should cover the possibility of divorce or bankruptcy of an owner which may trigger an "involuntary" transfer of stock or ownership interests. Generally, the other shareholders will not want the creditor to have any interest in the business upon dissolution of the owner's marriage or bankruptcy.

G. Terms. In addition to determining which events should be covered, the drafter must decide whether to use different payment terms and valuation formulas for different trigger events. The company or the remaining shareholders may be willing to pay more at a shareholder's death than they would upon termination of a shareholder's employment. While the price should be fair and reasonable in all cases, it is acceptable to use different prices and different terms in different situations.

There are several ways to determine purchase price in a buy sell agreement. Four of the most common are: (1) a stipulated value that is a fixed price set by periodic agreement of the owners; (2) book value, that is the historic cost of the company's assets less its liabilities; (3) a formula, which is usually a capitalization of earnings or multiple of book value approach; and (4) an appraisal. Each of these approaches has its advantages and disadvantages.

Methodology	Stipulated Value	Book Value	Formula	Appraisal
Advantages	Simple to arrive at the price and can be calculated without involving appraisers or accountants.	Simple to arrive at the price. Calculation is methodical and not subject to dispute.	Certain industries may gravitate toward accepted formulas which enhance the general acceptance of the valuation. Allows for averaging of financials to normalize results. Adjustments for unusual events and tax items can lead to a more precise valuation.	An appraisal may be the most accurate manner in valuing a business in that it typically will consider formula based approaches for measuring the value as well as recent sale history for comparable businesses.
Disadvantages	Potential for inaccurate estimation of fair value. May become outdated over time as owners fail to update.	Reflects historical values of assets thus not true reflection of business. Does not factor in goodwill and other intangibles.	Calculations can be complex and require consultation with accountants.	An appraisal can be the most expensive manner in which to value a business. An appraisal may take several months to complete.

- **Practice Pointer**. If a stipulated value is provided for in the agreement a secondary method is advisable if the stipulated value is outdated.

H. Funding the Buy Sell with Insurance. It is possible to fund a purchase by establishing a fund or borrowing. The most common way to fund a buy sell at the death of an owner is through the use of insurance on the owner's life. Insurance can provide immediate liquidity at the owner's death. When purchasing life insurance on an owner, the company or the other shareholders need to consider how long they expect the obligation to exist. For a buyout at death, it can be difficult to assess the time period for which the risk needs to be covered by insurance. Timing can depend on the life expectancy of the owner, the cash flow expectations of the entity, and the owner's plans for possible sale of the company during lifetime. Where the funding needs are short term, term life insurance may be advisable. Where the funding needs may last for the owner's entire lifetime it may be more advisable to purchase permanent insurance versus term insurance. Since the need for the insurance may be very long term and term insurance generally becomes too expensive to maintain as the insured ages, the insurance should either be permanent insurance or have a feature that allows conversion from term to permanent so that the insurance will be in place when the buyout must occur.

- **Practice Pointer**. Helping clients determine the timeframe of the insurance need is critical to determining the appropriate type of policy to use.

In addition to determining the type of insurance that should be purchased, it is important for the parties to consider carefully how much insurance will be needed. Too often, clients insure at the then value of the business and do not provide for growth potential. While it is certainly possible to fund the buyout with cash from the insurance proceeds and a note for the balance, the parties should be aware that financing will then be needed and the deceased shareholder's estate will not be cashed out. If one of the shareholders' objectives was to have his or her family's economic security protected from the vagaries of the business, that objective will not be met.

- **Practice Pointer**. As the owner ages, the premiums required to insure the owner's life will increase and could potentially become cost prohibitive. Before undertaking an insurance funded buy sell strategy consider whether the premiums will eventually be more than the business is able to afford.

It is important to raise this issue when the insurance decision is made so that, if there is a gap in funding, everyone is aware of and can plan for that possibility. It is common to see agreements that are underfunded on the owner's death with insurance; it is rare to see agreements that are overfunded.

Finally, once the amount of life insurance has been determined, it is critical to also consider how the insurance should be owned. The business may own insurance to cover the cost of replacing a key person or to fund a buyout of the deceased shareholder's interests. A planner must carefully determine whether company-owned life insurance may have the effect of increasing the value of the business for estate tax purposes. Alternatively, the insurance may be owned by co-owners to fund a cross purchase agreement or by the deceased owner through an irrevocable life insurance trust to fund the payment of estate taxes without the need to sell any of the business interests. Exhibit C contains the description, common objectives, tax consequences, and benefits and drawbacks of an irrevocable life insurance trust.

- **Practice Pointer**. Life insurance is not a static asset. It should be reviewed regularly to determine that it continues to meet the needs and that the needs have not changed. Review of the insurance should be a regular part of your annual client meeting.

I. Implications of Valuing the Business. Determining the value of the business during the owner's life or at death can be important for a number of reasons. The following table summarizes a few of the ways in which a valuation can impact a succession plan.

ESOP Rules	Statute of Limitations for Gifts	Statute of Limitations for Sales
If an employee stock ownership plan is established, tax laws prohibit the ESOP from paying more than adequate consideration for stock purchased from a shareholder.	Taxable gifts of stock must be reported on a gift tax return to start the statute of limitations under which the IRS may challenge the valuation of the business interest.	A sale of stock is not required to be disclosed on a gift tax return. However, reporting the sale on a gift tax return can be advisable to start the statute of limitations for challenging any valuation associated with the sale. See Treas. Reg. § 301.6501(c)-1(f)(4).
Post-Death Administration	**Trigger Event under Buy-Sell**	**Establishing Income Tax Basis**
A valuation may be necessary to complete an inventory of the probate estate, to determine the extent that the business will be allocated to shares under a trust, or to calculate the amount of the decedent's gross estate.	A valuation may be required in order to comply with a buy-sell triggering event such as divorce, incapacity or bankruptcy.	Beneficiaries inheriting stock at the owner's death will generally receive a cost basis equal to the fair market value of the stock. The valuation may determine the cost basis of the inherited stock.

V. Charitable Planning for The Family Business Owner

A. Outright Gifts to Charity During Life or at Death. A business owner who is charitably inclined has many options for giving. The simplest type of gift made after a client's death is an outright gift to a public charity as a specific devise in the client's will or revocable trust. The client's estate will receive an estate tax charitable deduction for the stock gift equal to the fair market value of the shares on the client's date of death. IRC § 2055(a). If instead the client gives the stock to charity during life, the client will receive income and gift tax charitable deductions equal to the fair market value of the stock on the date of the gift. IRC §§ 170(e)(1)(A) and 2522. The client will also avoid recognition of capital gain due to the appreciation of the ownership interest.

The client donating stock during life may also need to obtain an appraisal of the business interest in order to substantiate the income tax deduction. For a lifetime gift with a value greater than $5,000 (or $10,000 for non-publicly traded stock), the donor must obtain a “qualified appraisal” from a “qualified appraiser” for the donated corporate interest and file an “appraisal summary” (IRS Form 8283) within the required time limit. Treas. Reg. § 1.170A-13(c). If the donated stock is worth more than $500,000, the donor must attach a copy of the appraisal to Form 8283. IRC § 170(f)(11)(D); Treas. Reg. 1.170A-16(e).

B. <u>Characterization of Pre-Arranged Sale.</u> One caveat for the client to consider is the possibility that, under certain circumstances, the IRS will not allow the client to avoid recognition of built-in gain on the donation of the stock. The Service’s position is something akin to the step transaction doctrine because it may be a foregone conclusion that the charity will not want to own the stock, and both the client and the charity have every incentive to arrange the company’s redemption of the stock from the charity after the client completes the donation. The IRS may characterize the donation to the charity and the company’s subsequent redemption of the stock as a “prearranged sale.” If this occurs, the client must pay income tax on the built-in capital gain when the company redeems the donated stock from the charity.

C. <u>Pre-Arranged Redemption.</u> A redemption is a prearranged sale if either of the following two conditions exists: (1) The charity has a legally binding obligation to sell the interest to the business entity, or the charity otherwise can be compelled to sell the interest, Rev. Rul. 78-197, 1978 C.B. 83; or (2) The company’s redemption of the stock from the charity is a “practical certainty” at the time of the gift. *See* Ferguson v. Comm’r, 174 F.3d 997 (9th Cir. 1999), *aff’g* 108 T.C. 244 (1997) (finding donors taxable on the capital gain from stock transferred to charity because, on the date of the gift, the company had approved a merger and the corporate interest was equivalent to a right to receive sales proceeds). *But see* Rauenhorst v. Comm'r, 119 T.C. 157 (2002) (upholding Rev. Rul. 78-197 by finding that there was no legal obligation to sell at the time of the gift and the donor should recognize no income on the charity's subsequent sale of the stock).

Care must be taken to avoid a prearranged sale by waiting to negotiate the existence and the terms of any redemption until after the gift is complete. The company must not to adopt any resolution to make an offer for the donated shares until after the gift is complete. It is also prudent for the donor, the company, and the charity to defer any discussions of a redemption until after the donor makes the gift.

An added benefit to transferring shares of a closely-held business to charity is that the transaction may accomplish the donor's business succession goals by increasing the portion of the business owned by the client's children if, over time, the company can buy back the stock from the charity. By gifting to charity and *later* coordinating the company's redemption of the charity's shares, the client in effect augments all of the other shareholder's ownership in the business proportionately.

For example, if children own stock in the company, this strategy increases the children's ownership share and/or voting control in proportion to the total shares outstanding. Assume Mom started a C-corporation having 100 shares of outstanding stock and has two sons involved in the business, each of whom owns 30 shares. Mom transfers 40 shares of stock to her favorite college. Mom's corporation later redeems the charity's shares. As a result, each son's ownership in the company increases from thirty percent to fifty percent without creating a taxable gift or using any of Mom's lifetime gift tax exemption.

Shareholder	Before Gift	Before Gift	After Gift	After Redemption	Final Ownership
Mom	40 shares	40%	0 shares	0 shares	0%
Son 1	30 shares	30%	30 shares	30 shares	50%
Son 2	30 shares	30%	30 shares	30 shares	50%
Charity			40 shares		
Total	**100 shares**	**100%**	**100 shares**	**70 shares**	**100%**

By gifting to Mom's favorite charity, Mom moved appreciated stock out of her estate, paid no gift tax on the transfer, received a charitable income tax deduction with a five-year carry forward deduction for income tax purposes, benefited a charity, and effected a nontaxable transfer of 40 percent of the ownership in the corporation to her sons.

D. Charitable Gift Annuity. An additional strategy for a charitable transfer of a business interest is the use of a charitable gift annuity ("CGA"). A CGA is a contract between the donor and the issuing charity. The client transfers an interest in a closely-held business to the charity and receives in exchange an annuity payable to one or two annuitants for life. Similar to the redemption strategy discussed above, the charity then sells the business interest to the company at fair market value. The benefit of a CGA is that it is considerably less complex than the charitable trusts addressed below. The present value of the annuity must be ninety percent or less of what the client transfers to the charity. The present value of the annuity is determined by the amount of the annual annuity payment, the age of the annuitant at the time the charity issues the CGA, the installment period for payment, e.g., quarterly, semi-annually, etc., and the applicable federal rate. The amount by which the value of the property transferred to the charity exceeds the actuarial value of the annuity is a deductible charitable gift. There is a potential problem for the charity, however. Because the CGA is a contractual obligation, the charity must continue to make the annuity payments even if the gifted assets are not sufficient to pay the entire annuity commitment. Note, too, that there is a potential self-dealing problem if the charity is a private foundation and not a public charity. I.R.C. § 4941(d)(2)(F). Even if the recipient organization is a public charity, the company should ensure that the redemption is an arm's-length transaction at fair market value.

E. Charitable Remainder Trust. A charitable remainder trust ("CRT") is another possible gifting strategy that could provide payments to the client during retirement. A client transfers stock to a CRT and retains an income interest for a stated term, one or more lives, or a permitted combination of the two. The remainder of the trust passes to the client's designated charity at the end of the stated term, often at the time of the donor's death.

The IRS allows two types of CRTs. IRC § 664. The charitable remainder annuity trust ("CRAT") provides a fixed annual payment, calculated one time at the creation of the trust, to the noncharitable beneficiary. The fixed annual payment of a CRAT must equal at least five percent (but no more than 50 percent) of the initial trust value. The charitable remainder unitrust ("CRUT") provides a fixed payment based on the value of the trust, revalued annually, to the noncharitable beneficiary. The CRUT trustee makes annual payments of at least five percent (but no more than 50 percent) of the trust corpus to the noncharitable beneficiary based on the designated fixed unitrust percentage provided in the trust.

A donor can vary a CRUT's payment structure in a number of ways. One particularly beneficial structure for a client giving away a closely-held business interest is a “flip” CRUT. The trustee makes payments only from the actual income generated by the trust assets until a stated triggering event occurs, at which time the flip CRUT converts to a standard CRUT and the noncharitable beneficiary begins to receive the income payment stream. The client cannot control the timing of the trigger event. For purposes of business succession planning, a client might consider using a flip CRUT because it allows for an initial contribution of non-income producing property. After the triggering event (the trustee sells the stock back to the company, for example), this arrangement provides retirement income to the donor that is independent of the success of the business. After the trustee’s sale of the stock, the CRUT holds cash that the trustee can invest in a diversified portfolio of publicly traded securities. The CRUT may also help transfer control of the company to the children in the same way as an outright charitable gift and a CGA if the children are already shareholders at the time of the redemption.

The lifetime flip CRUT provides an immediate income tax deduction equal to the present value of the remainder interest in the trust that will eventually pass to charity. IRC §§ 170(f)(2)(A), 664(d)(2). The CRUT is exempt from federal income tax and it pays no capital gains tax when it sells the stock. IRC § 664(c). The client also avoids paying tax on the stock’s built-in capital gain.

F. Charitable Lead Trust. It is possible for a client to achieve transfer tax savings and benefit both family and charity. A charitable lead annuity trust (“CLAT”) is a trust that pays a guaranteed annuity to a charitable beneficiary for a stated term of years or a specified person’s lifetime. At the end of the stated term, the trustee pays the remainder of the trust to noncharitable beneficiaries, typically the client’s children.

There are two types of CLATs: grantor and non-grantor. A non-grantor CLAT does not allow the donor to take an income tax charitable deduction, but does allow gift and estate tax deductions for the value of the charity's lead interest. IRC §§ 2522(c)(2)(B) and 2055(e)(2)(B). Instead, the non-grantor CLAT itself is allowed a charitable income tax deduction for the annuity payments made to charity. IRC § 642(c). A grantor CLAT allows the donor to take an income tax charitable deduction for the value of the charitable lead interest, but the donor is then taxed annually on the CLAT income during the term of the charity's lead interest. The client's income tax deduction is limited to 30 percent of the client's adjusted gross income, and the five-year carry-forward is not available for any unused charitable deduction. Priv. Ltr. Rul. 8824039. In addition, if the client does not survive the trust term, a portion of the income tax deduction that the client claimed in the year of funding is recaptured on the donor's final income tax return. IRC § 170(f)(2)(B). Neither the donor nor the trust receives an income tax charitable deduction for the annuity payments made to the charity.

A CLAT reduces the gift tax or estate tax on the transfer of the business interests to the client's children if the trust assets outperform the 7520 rate used to compute the value of the charity's lead interest in the trust. This is because the children's actual remainder will be larger than the value of the remainder for tax purposes at the time the trust is created. Thus, the lower the 7520 rate, the easier it is to "beat the rate" and transfer value to the remainder beneficiaries free of transfer tax. In addition, the lower the 7520 rate, the greater the present value of the charity's lead interest and the greater the charitable deduction. The estate's charitable deduction for the charitable lead interest reduces the overall estate tax due at the time of the business owner's death.

If the stock held by a CLAT pays sufficient dividends, the trustee may be able to satisfy the annuity payments to the charity using that income. If the dividend payments are insufficient or nonexistent, the trustee can distribute stock to the charitable beneficiary in order to satisfy those annuity payment obligations. The company can then redeem the stock from the charity. If the company redeems the stock from the CLAT, self-dealing may be a problem unless the corporate redemption exception of IRC § 4941(d)(2)(F) applies. In addition, IRC § 4943 prohibits private foundations and charitable trusts from retaining excess business holdings. To the extent that the CLAT and all disqualified persons in the aggregate own more than 20 percent of the voting stock of the company, the charitable trust has excess business holdings. The charitable trust can keep no more than a de minimis interest in a closely-held company (no more than two percent). The excess business holdings rule also requires the CLAT to divest itself of the closely-held stock over a five-year period.

Exhibit D provides a quick comparison of Charitable Remainder Trusts and Charitable Lead Trusts including their typical terms and tax consequences.

VI. Hypothetical Planning Scenarios

Planning Hypothetical No. 1: Next generation not interested in continuing business and owner desires to keep wealth within the Family

Facts: Widow owns 100 common shares of ABC Co., a C-corporation. Widow has two adult sons neither of which are interested in running ABC. ABC has a management team in place. Widow is retired and relies on dividends from ABC as she has few liquid assets. Widow wants her sons to inherit all of her estate, including her interest in ABC. Widow has a taxable estate for estate tax purposes and wants to minimize estate tax at her death. Widow is expected to live 15 to 20 more years.

Planning Solution:

Step 1: Widow hires a business consultant to evaluate management of ABC and implement any recommendations to improve prospects for sale to a prospective buyer.

Step 2: Widow exchanges her 100 common shares for 30 voting shares and 70 preferred non-voting shares with a 4% divided in a tax-free reorganization.

Step 3: Widow creates an intentionally defective irrevocable grantor trust ("IDGT") for each of her sons. The trust provides for distributions to each son for their lifetime for health, education, maintenance and support. The trust is grantor trust for income tax purposes so widow pays all of the income tax on the trust's taxable income. The trusts are designed to be excluded from widow's estate and from each son's estate for federal estate tax purposes.

Step 4: Widow makes a taxable gift of 15 voting shares in ABC to each trust. Widow obtains an appraisal of the value of the voting shares and files a gift tax return to report the gift. As a result of lack of marketability and lack of control discounts, the appraisal determines that the value of the gift for gift tax purposes is at a 15% discount to ABC's net asset value. Any appreciation in the value of ABC subsequent to the gift to the trusts will not be subject to gift or estate tax in the widow's estate or the estate of her sons.

Step 5: Widow creates a grantor trust for the benefit of her descendants funded with cash and marketable securities. She later sells to the trust 20 shares of ABC stock in exchange for a promissory note. The sale is not taxable to her because the grantor trust is a disregarded entity. Widow will receive payments on the promissory note during its term and will pay taxes on the trust's income while the trust is a grantor trust.

Step 6: Widow transfers her 50 non-voting shares in ABC to her revocable trust which provides for those shares to be added equally to the trusts for her sons upon her death. Widow receives the 4% dividend from ABC for the remainder of her life to assist with living expenses. After widow's death, XYZ company acquires the voting stock from the trusts for cash leaving each son with liquid assets in their trust.

Relevant Dates for Planning with IDGT

Date	Event	Responsible Parties	Completed
12/15/2022	Trust Agreements finalized		
12/15/2022	ABC approves recapitalization plan and issues voting and non-voting shares of stock		
12/15/2022	Open trust bank accounts—grantor trusts, accounts use client's social security number		
12/31/2022	Gift of voting stock to each trust using stock power instrument		
2/15/2023	Appraisal completed		
2/28/2023	Update corporate books and records		
4/15/2023	2022 gift tax return due, report gift of voting stock		

Planning Hypothetical No. 2: Next generation not interested in continuing business and owner desires to benefit charity.

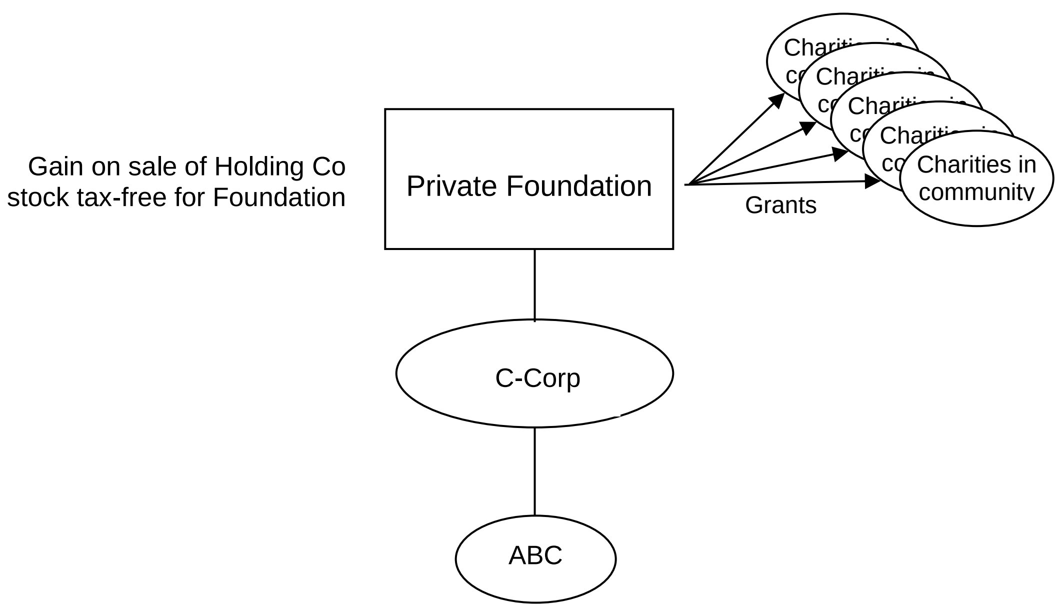
Facts: Client owns 100 membership units of ABC LLC. Client is ready to retire and does not need income or proceeds from the sale of ABC for his financial support. Client built ABC from scratch and has zero basis in ABC for income tax purposes. Client has significant taxable income from other investments and can offset his taxable income with a charitable deduction. Client is interested in creating a private foundation to benefit the local community.

Planning Solution:

Step 1: Client creates a private foundation by trust agreement under local law. Private foundation applies for recognition as 501(c)(3) tax exempt entity. To protect the 501(c)(3) status of the private foundation, it would need to create a C-corp subsidiary to hold all of its ownership interest in ABC.

Step 2: Client makes lifetime gift of 100 units in ABC to private foundation. Client receives charitable income tax deduction for fair market value of gift of ABC which can offset other taxable income. Client also avoids recognition of built in gain on ABC for difference between cost basis and fair market value.

Step 3: Private foundation is required to sell at least 80% of the ABC units within five years. The private foundation will use the sale proceeds to fund its charitable mission. Client and client's family may serve as directors of private foundation.



Planning Hypothetical No. 3: One child wants to take over the family ranch and other child is not interested. Father wants to treat children equally.

Facts: Rancher owns 100% of Ranch LLC, which owns 640 acres of ranch land and equipment. The value of Ranch LLC is $7 million. Rancher has $3 million of other liquid assets. Daughter A works on the ranch and wants to take it over when Rancher retires. Daughter B is not interested in working on the ranch. Rancher wants Daughter A to receive Ranch LLC upon his death but wants to treat his children equally. Rancher is expected to live another 10 to 15 years and anticipates the value of his assets will grow at 5% per year.

Planning Solution:

Step 1: Rancher transfers ownership of Ranch LLC to his revocable trust.

Step 2: Rancher consults with his financial and insurance advisor and acquires an insurance policy to provide for additional liquidity to pay estate tax and other expenses at his death.

Step 3: Rancher's revocable trust provides that upon his death the remaining trust estate will be divided into equal shares for his two daughters. The Trustee is instructed to have the value of Ranch LLC valued by a qualified appraiser. The trust agreement provides that Ranch LLC will be allocated to the share for Daughter A but not to exceed the value of such share. The remaining assets will be allocated to the share for Daughter B except that Daughter A has a right of first refusal to acquire any interest in Ranch LLC from Daughter B for fair market value as determined by an appraisal. The terms of the right of first refusal allow Daughter A to pay the purchase price 50% with cash and 50% with a five-year promissory note with adequate interest.

Planning Hypothetical No. 4: Next generation not interested in continuing business and owner wants to sell business to third party and minimize estate tax.

Facts: Wife owns 100 common shares of ABC Co., a C-corporation. Wife is married to Husband who is Wife's second spouse. Husband is not the father of Wife's two sons, A and B. A and B and Husband do not get along well. Wife and Husband do not have a premarital agreement. Wife wants to provide Husband with sufficient resources to maintain his standard of living and wants the remainder of her estate to pass to her sons. Wife plans to sell the business in the next five years and retire.

Planning Solution:

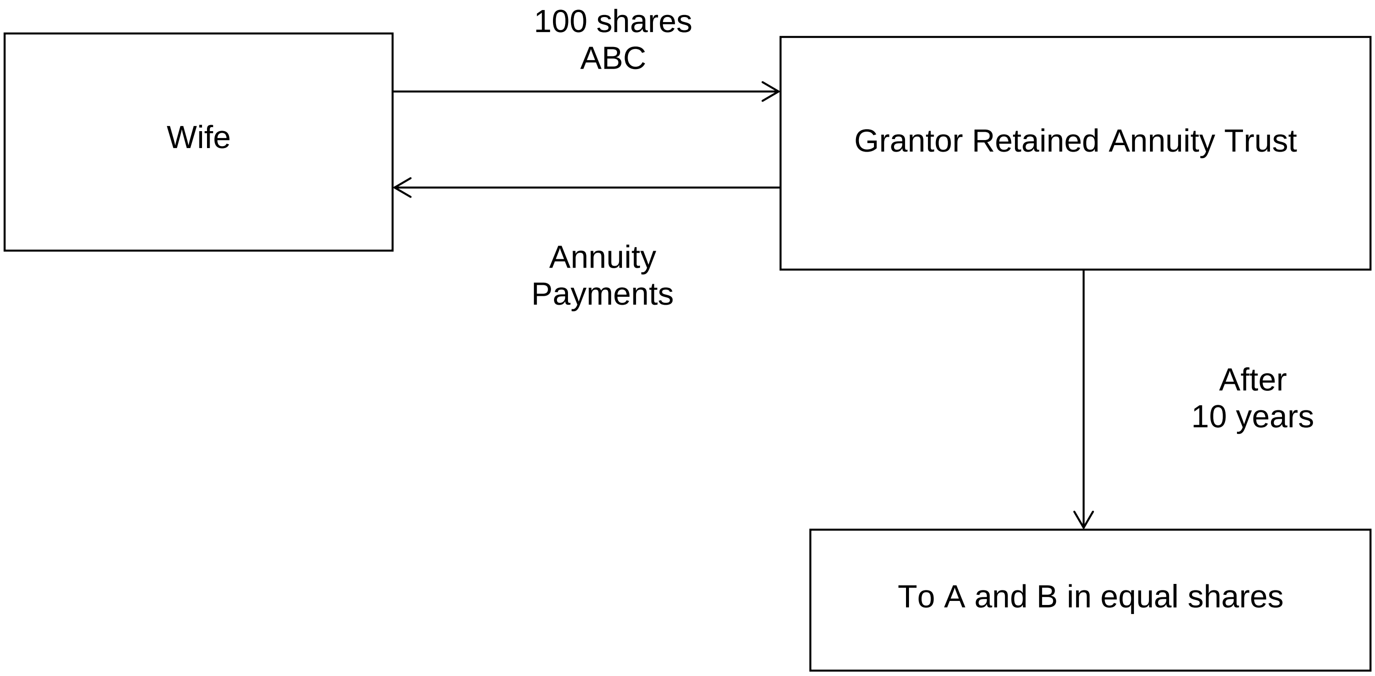
Step 1: Wife identifies and trains a candidate to assume her role as President of ABC. Wife adds two successful business owners unrelated to her family to the Board of Directors.

Step 2: Wife and Husband negotiate a post-nuptial agreement in which Husband agrees to waive his elective share rights and other spousal rights in the event of death or divorce in exchange for Wife agreeing to leave their residence outright to Husband and certain other bequests.

<u>Step 3</u>: Wife creates a grantor retained annuity trust ("GRAT") with a term of 10 years which provides that upon the termination of the GRAT, the remaining trust estate is distributed in equal shares to A and B. The GRAT provides for annual payments to Wife the present value of which is equal to the remainder interest in the GRAT so that no taxable gift results from Wife funding the GRAT, also known as a zeroed-out GRAT. The Section 7520 rate at the time of creation of the GRAT is 1.4%.

<u>Step 4</u>: Wife transfers ownership of her entire 100 shares of ABC to the GRAT. Each year a percentage of the shares in ABC are distributed in kind from the GRAT to Wife to satisfy the required annual payment.

<u>Step 5</u>: In the fifth year of the GRAT, XYZ purchases all 100 shares of ABC in part from Wife and in part from the GRAT. The ABC shares appreciated 30% between when the shares were contributed to the GRAT and when the shares were sold. The proceeds from the sale of ABC stock continue to be held in the GRAT. The amount by which the ABC shares appreciated in excess of the Section 7520 rate is able to transfer from the GRAT to the sons free of transfer tax.



Sample Business Succession Plan

Business Succession Plan

FOR: John Doe

BUSINESS: ABC Company

DATE: March 1, 2022

FROM: Law Firm LLP

1. Strategic Objective and Goal Articulation. In consultation with the Owner's team of advisors in the fields of law, accounting, tax, insurance, banking, business and valuation, the Owner has developed a succession plan for the Business. The succession plan incorporates the Owner's ultimate goals and objectives both personally and for the Business. The Owner considered various timing scenarios for exiting the Business including the Owner's vision of the Business and the Owner's level of involvement in the Business in one year, two years, five years and more than ten years. A discussion was had about the Owner's interest in reducing the Owner's time commitment to the Business from full-time to part-time and the potential for serving as a consultant after exiting the Business pursuant to a written consulting agreement with new ownership.

Three options were presented to the Owner: (i) selling the Business to an unrelated third-party in an arms-length transaction; (ii) transferring ownership to the Owner's family members by a lifetime gift, a sale, inheritance or a combination of gift, sale and inheritance; and (iii) leaving stock in the Business to one or more charities by gift, testamentary bequest, charitable gift annuity or charitable trust. As part of the review of these options, the Owner considered the value of the business and whether a whether obtaining a professional appraisal of the Business would be helpful. The Owner's personal financial planning and needs for retirement were discussed including to what extent a lump sum payment or income stream would be needed from the Business in order to provide for the Owner's financial security. A discussion was also had about how the ultimate disposition of the Business would impact the future and well-being of the Business's employees and customers.

It was ultimately decided by the Owner that:________________________________
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2. Management and Talent Assessment. The Owner undertook a thorough review of the key employees responsible for the successful management of the Business. The Owner recognizes that developing a successful management team is critical to preserving the intrinsic value of the Business during and after the Owner's exit. The current management of the Business including its officers, Board of Directors and key personnel are described on the Organizational Chart attached as Addendum "A" hereto. The Organizational Chart attached as Addendum "B" reflects how the Business will be managed after the Owner has exited the Business. The Owner has identified the future leadership of the Business and committed to developing these persons through training, education, mentorship, compensation and incentives. A discussion was also had about contingency planning in the event key leaders die, become disabled or leave the Business.

The following decisions were made:____________________________________

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3. Communication with Family and Stakeholders. A discussion was had about the importance of communicating the Owner's succession plans with family members, the management team and the stakeholders in the Business. Specific attention was given to the collective personality traits of the family members, how they get along with each other and the potential for family disputes that could interrupt the operation of the Business. The Owner was presented with the concept of a family council in which family members with an ownership interest in the Business meet regularly to discuss their positions on issues involving the Business and review the Business finances.

The Owner reached the following conclusions regarding communication of the succession plan:____

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4. Corporate Documents and Buy-Sell Provisions. The governing documents of the Business were reviewed with respect to classes of stock, voting and non-voting rights, rights to dividends or distributions and the resultant effect of the Owner's death, retirement, disability divorce or bankruptcy on the ownership and control of the Business. Transfer restrictions were reviewed and the effect of such restrictions on the valuation of the Business. A review was also undertaken of the minute book, resolutions and state required filings to ensure that the Business is observing appropriate corporate formalities.

The following decisions were made and the person(s) responsible for each item are noted:____

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5. Estate Planning. The Owner's personal estate plan was reviewed including the Owner's will, revocable and irrevocable trusts, financial and health care powers of attorney. A discussion was had about how ownership of the Business would pass under the Owner's current estate planning documents, resulting changes in voting control and any changes that are necessary to implement the Owner's desired succession plan. Consideration was also given to the estate planning documents in place with respect to other current and future owners of the Business and whether revocable or irrevocable trust planning would benefit those owners. The current federal estate and gift tax exemption amounts were discussed along with strategies for minimizing transfer tax.

The following observations about the Owner's estate plan were noted:__________
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The following additional steps are needed and the person(s) responsible are noted:
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6. Financial Considerations. The Owner consulted with a financial advisor to project cash flow needs and sources of retirement income. Income tax planning was considered in consultation with the accountant for the Business. The Owner's life insurance policies were reviewed with regard to the need for liquidity in the Business and to pay estate tax upon the Owner's death. The Business loan documents were reviewed with respect to treatment of the Owner's death and changes in ownership. The capital structure of the Business, the ratio of debt to equity and the classes of equity were discussed. Consideration was given to the extent to which the Business would provide a source of income or lump sum payment to the Owner.

Options for creating an income stream were discussed including: (i) retaining non-voting preferred stock with guaranteed dividends; (ii) selling the Business in exchange for a secured promissory note with amortization of income and principal payments designed to match the Owner's cash flow needs; and (iii) contributing stock to a charitable gift annuity or charitable remainder trust in exchange for an annuity payment or fixed income interest.

It was decided by the Owner that:______________________________________
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Exhibit A: Grantor Retained Annuity Trust

Description	Common Objectives	Tax Consequences	Benefits	Drawbacks
The grantor (the trust creator) creates an irrevocable trust and funds the trust with property that is likely to produce income or to appreciate during the trust term; The grantor transfers property to the trust and retains the right to receive annuity payments for a specific period of years, the term of the GRAT; The grantor is treated as the owner of the trust property for income tax purposes; If the grantor dies before the end of the trust term, a portion (or all) of the trust property will be included in his or her gross estate for estate tax purposes; If the grantor survives the term of the trust, any remaining trust property will pass to the remainder beneficiaries, usually the grantor's children or grandchildren, without incurring any estate or gift tax;	Transfer appreciating/income-producing assets to children over time. Retain standard of living and an income stream. Minimize estate and gift taxes.	**Income tax**: Income and gain/loss events are taxed to the grantor (the trust is disregarded for income tax purposes as a "grantor trust"). **Gift tax**: The transfer to the trustee is a taxable gift that does not qualify for the $16,000 annual gift tax exclusion, so it uses a portion of the grantor's $12,060,000 (for 2022) lifetime gift exclusion amount. The amount of the gift is (i) the value of the assets transferred from the grantor to the trustee reduced by (ii) the actuarial value of the annuity payments from the trustee to the grantor. The amount of gift can be zero or nearly zero if the trust is structured correctly. If the trust's total return during the trust term exceeds the applicable §7520 rate, then that excess passes to the grantor's children without any additional gift tax.	The grantor retains an income stream. A GRAT is an effective freeze of asset values at the time of the gift. The appreciation is removed from the grantor's taxable estate and passes tax free to remainder beneficiaries. The initial gift uses little to no gift tax exemption.	This is not a vehicle for generation-skipping transfer (GST) tax planning. GRATs can be administratively complex. There is estate tax inclusion for the term of the GRAT. The initial gift does not qualify for the annual exclusion.

Exhibit A: Grantor Retained Annuity Trust Continued

Description	Common Objectives	Tax Consequences	Benefits	Drawbacks
To the extent the fair market value of the property initially transferred to the trust exceeds the fair market value of the grantor's retained annuity interest, the grantor has made a taxable gift to the remainder beneficiaries of the trust; and The grantor files a gift tax return to report the transfer to the trustee. The return should include a qualified appraisal of any hard-to-value assets that are transferred to start the statute of limitations period running with respect to the gift tax value.		**Estate tax**: If the grantor dies during the trust term, the full value of the trust assets are likely included in the grantor's estate for estate tax purposes. If the grantor survives the trust term, the annuity payments that the grantor received and retained are included in the grantor's estate for estate tax purposes. **Generation skipping tax:** GST exemption may not be allocated until the end of the estate tax inclusion period.		

Exhibit B: Installment Sale to Grantor Trust

Description	Common Objectives	Tax Consequences	Benefits	Drawbacks
The grantor (the trust creator) creates an irrevocable trust that is a grantor trust for income tax purposes, but does not benefit the grantor and is not revocable or amendable by the grantor. The grantor transfers some assets to the trustee, usually cash in the amount of 10% of the value of the assets that will be later sold to the trust. The grantor sells additional assets to the trustee that are expected to appreciate rapidly and/or generate significant income in exchange for an installment note. The trustee pays the grantor back installment payments of interest only, or principal and interest, on the note until it is paid in full or until a specified date. The grantor files a gift tax return to report both the transfer and the sale to the trustee. The return should include a qualified appraisal of any hard-to-value assets to	Transfer appreciating/income-producing assets to children over time. Retain standard of living and an income stream for a period of time. Minimize estate and gift taxes.	**Income tax:** Income and gain/loss events are taxed to the grantor (the trust is disregarded for income tax purposes as a "grantor trust"). **Gift tax**: The transfer to the trustee is a taxable gift that does not qualify for the $16,000 annual gift tax exclusion, so it uses a portion of the grantor's $12,060,000 (for 2022) lifetime gift exclusion amount. Unless the valuation of the assets is incorrect, the sale to the trustee is not a taxable gift. If the trust's total return during the note term exceeds the note's interest rate, then that excess passes to the trust beneficiaries without any additional gift tax. **Estate tax**: The grantor retains no control over the trust after it is created, so the trust assets are excluded from the grantor's estate for	The grantor retains an income stream from the note. This is an effective freeze of asset values at the time of the sale. Everything other than the installment payments is removed from the grantor's taxable estate and passes tax free to remainder beneficiaries. This is a good vehicle to use the generation-skipping transfer (GST) tax exemption.	The initial gift to the trust does not qualify for the annual exclusion and uses some gift tax exemption. IDGTs can be administratively complex. There is estate tax inclusion for the installment payments.

Exhibit B: Installment Sale to Grantor Trust Continued

Description	Common Objectives	Tax Consequences	Benefits	Drawbacks
start the statute of limitations period running with respect to the gift tax value. After the note is paid in full, all of the trust assets are available to provide for the beneficiaries of the trust.		estate tax purposes. The installment payments on the note that the grantor received and retained are included in the grantor's estate for estate tax purposes. **Generation skipping tax**: GST exemption is allocated to any gifts to the trust.		

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Exhibit C: Irrevocable Life Insurance Trust

Description	Common Objectives	Tax Consequences	Benefits	Drawbacks
The grantor (the trust creator) creates an irrevocable trust that may or may not be a grantor trust for income tax purposes, but does not benefit the grantor and is not revocable or amendable by the grantor. Either the grantor transfers an existing life insurance policy to the trustee, or preferably the trustee purchases a life insurance policy that insures the grantor. The grantor pays the insurance premiums each year, and the premium payment is treated as a contribution to the trust. Certain individuals will be granted withdrawal rights over the contribution made each year; these are called *Crummey* withdrawal powers. These powers are necessary to qualify the contribution for the annual gift tax exclusion each year. Notice of this withdrawal right must be sent to	Transfer death benefit proceeds to beneficiaries without inclusion of proceeds in taxable estate. Minimize estate and gift taxes.	**Income tax**: Income and gain/loss events are taxed to the grantor if the trust is a grantor trust (the trust is disregarded for income tax purposes as a "grantor trust"). If the trust is not a grantor trust, the trust pays tax to the extent there is income generated. **Gift tax:** The transfer of an existing policy to the trustee is a taxable gift that does not qualify for the $16,000 annual gift tax exclusion, so it uses a portion of the grantor's $12,060,000 (for 2022) lifetime gift exclusion amount. The purchase of a new policy is not a taxable gift. Payments of premiums on an annual basis will qualify for the annual gift tax exclusion if beneficiaries have *Crummey* withdrawal rights. **Estate tax:** The grantor retains no control over the trust after it is created, so the trust assets (including	The grantor excludes the life insurance and death benefit from his or her taxable estate. The death benefit can pass tax free to beneficiaries on the grantor's death.	The initial gift of an existing policy to the trust does not qualify for the annual exclusion and uses some gift tax exemption. Annual *Crummey* notice letters are required to beneficiaries. There is estate tax inclusion for three years if an existing policy is transferred to the trust.

Exhibit C: Irrevocable Life Insurance Trust Continued

Description	Common Objectives	Tax Consequences	Benefits	Drawbacks
beneficiaries each time a contribution is made. At the death of the grantor, the insurance proceeds will pass to the beneficiaries of the trust. The proceeds of the policy are excluded from the grantor's taxable estate. If the grantor transferred an existing policy to the trust, the grantor must survive three years from the transfer to exclude the proceeds from his or her taxable estate.		the death benefit of the insurance) are excluded from the grantor's estate for estate tax purposes. If the grantor transfers an existing policy to the trust, the grantor must survive three years from the transfer to exclude the proceeds from his or her taxable estate.		

Exhibit D: Comparison of Charitable Options

Option	Public charity	Supporting organization	Private Foundation
Characteristics	Operating charity in the community, such as school, church, hospital. Receipt and ownership of Company stock would be incidental to primary charitable mission.	New charitable organization closely affiliated with one or a small number of operating charities.	New charitable organization not related to any other organizations.
Limitations on beneficiaries of charity	Single charitable purpose benefitted by the bequest because the charity would be required to use its dividends and profits from Company ownership in furtherance of its own mission.	One or a small number of charitable organizations can be supported. The Supporting Organization must be organized and operated exclusively to benefit its "supported" charity(s), meaning the SO must transfer most of its income to its supported organization(s) annually and is limited to making grants to its supported organization(s) or otherwise in furtherance of the supported organizations' mission. Grants to unrelated charities would not be permitted. The supported charity(s) cannot be controlled by any members of the family.	Unlimited. Grants could be made to any charitable organization and for any charitable purpose (or scope of giving could be limited to specific field(s) of interest).

Exhibit D: Comparison of Charitable Options Continued

Option	Public charity	Supporting organization	Private Foundation
Who may control the charity	Controlled by its own board of directors	Supporting organization has its own board of directors, a majority of whom must be appointed by the sponsoring charity. The family could designate a minority of board members.	May be controlled by family or other individuals appointed by family (or company).
Who would control the Company	Charity, as majority shareholder, would elect Company board of directors.	Supporting organization, as majority shareholder, would elect Company board of directors.	Foundation, as majority shareholder, would elect Company board of directors.
Limitations on Company ownership	None, other than Charity's fiduciary duty to maintain reasonableness of its investment	No formal limitation, but it would be important that Company ownership is reasonable and fair to the supporting organization. For example, dividend payments must be sufficient to permit adequate annual grants (of at least 5% of net assets), and joint ownership with family, if any, may not unduly benefit family at expense of supporting organization.	A private foundation, together with its disqualified persons, is limited to owning no more than 20% of the shares of any single company. When shares in excess of this cap are given by gift or bequest, a foundation must dispose of them within 5 years of the gift or bequest. The IRS may grant an additional five-year divestiture period in cases involving unusually large gifts or bequests of diverse or complex business holdings if it determines sale during the first five years was not possible due to the size or complexity of the ownership.

Exhibit D: Comparison of Charitable Options Continued

Option	Public charity	Supporting organization	Private Foundation
When/if a sale of Company stock would be required	None, other than as needed for Charity to appropriately mange its investment portfolio	None, other than as needed for Supporting Organization to appropriately mange its investment portfolio	Within five years of the gift or bequest.
Limitations on selling Company shares to children or others	None, other than that sale must be on FMV terms	None, other than that sale must be on FMV terms and for cash	Disqualified persons would be prohibited from purchasing shares from the Foundation. This includes family members, the Company, and any officers or Directors of the Foundation and their families and 35%-controlled companies.
Exceptions to above limitations	N/A	N/A	The Company could redeem Foundation shares only if it made a uniform offer to all shareholders and on FMV terms. Children or other DP's could purchase shares from estate, but only pursuant to pre-existing options.
S-corp considerations (because owernship of S-corp stock is taxed as unrelated business income tax (UBTI))	If Company stock is a substantial investment for Charity, conversion of Company to C-corp status would be required	Assuming Company stock would be primary asset of Supporting Organization, conversion of Company to C-corp status would be required	Assuming Company stock would be primary asset of Foundation, conversion of Company to C-corp status would be required

Exhibit D: Comparison of Charitable Options Continued

Option	Public charity	Supporting organization	Private Foundation
C-Corp considerations	C-corp pays corporate income tax on its taxable income. Dividends from C-corp to Charity are tax free, as is the one-time sale of stock (individual shareholders would experience double layer of taxation at both corporate and individual level, however).	Same as for public charity	Same as for public charity
Steps needed to create	Assuming Charity exists today, just transfer documents and shareholder or other agreements as needed.	Supporting Organization would need to be formed - could be formed during life or as charitable trust in will. Once formed, it would be required to apply for and obtain 501(c)(3) status from IRS. Supported organizations would need to be identified and agree to participate, including appointment of individuals to serve on Supporting Organization's board.	Foundation would need to be formed - could be formed during life or as charitable trust in will. Once formed, it would be required to apply for and obtain 501(c)(3) status from IRS.