BUSINESS SUCCESSION PLANNING
Death, Disability, and Gifting

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Legal Experience

Ms. Desai's practice includes the counsel and representation of clients in business formations and transactions, as well as employment and other civil litigation. Prior to founding this firm, she served as an appeals judge for the State of Texas for several years. Her current client list primarily consists of local businesses in and around Central Texas, Houston, and Dallas.

Speeches and Papers 2008-2009

- *Estate Planning for Businesses*, Greater Austin Chamber of Commerce
- *Chambers of Commerce*, Remarkable Women's Conference
- *Winning and Losing Unemployment Claims*, South Texas College of Law CLE
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- *Pursuing a Legal Career*, South Asian Professionals of Austin

Legal Affiliations

- Leadership State Bar of Texas, Inaugural Class
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I. INTRODUCTION

The planning of an exit strategy for small businesses is dependent upon many factors, including the identity of those taking over the business, tax planning strategies and advantages, and the desires of the business owner or owners.

II. THE PERSUASION TO PLAN: GETTING THE CLIENT TO MAP THEIR ROUTE FOR AN EXIT STRATEGY

As you are well aware, business owners are an action-oriented group who think and plan mostly for the growth and success of their business. When it comes to planning for succession, however, the business owner rarely initiates the conversation. It normally arises in conjunction with a discussion of the business as a part of an estate plan or because the owner has been approached to sell his or her business.

Common beliefs held by business owners that prevent planning for death and disability:

- It is not going to happen to me or my employees
- I am too busy
- I can do it later
- I do not need any more conflict in my life
- If I do not think about it, it will work itself out
- My business is my retirement

A. Benefits of Planning.

When discussing the topic with a client, some benefits of planning which can be addressed are:

- Maximize tax savings
- Defer taxes
- Avoiding liabilities
- Protect your assets
- Providing for your family/ employees
- Leaving legacies
- Planning to save future costs
- Building retirement
- More profit
- Higher efficiency
- Greater peace of mind
- Clearer focus
- Increase the value of your business
- Give you more freedom

B. I have explained the benefits, how do I show my client the bottom line? Some of the benefits listed above might drive a client to plan, but the most impressive benefit is always a better bottom line.

1. <u>Estimate Estate Taxes</u>: A calculation of the amount of tax due upon death showing the owner what taxes become payable often leads the owner into succession planning. After calculation, the owner naturally looks for potential sources of funds to pay those taxes. The owner is forced to consider whether his or her business would have to be sold or restructured if he or she died or became disabled.

2. <u>If the client has been approached to sell the business,</u> a valuation can be helpful to persuade the client to make a plan, as the offer usually signals a business value. Whether the owner does or does not wish to sell the business at that time, the owner can be encouraged to evaluate his or her management team and its ability to operate on its own.

3. <u>What if there is no estate plan and no buyer?</u>

In this scenario, it is the attorney's burden to ask the client, "If the top manager or top managers leave abruptly due to death, disability or other reasons, will the business processes of the business surely suffer interruption?" The likely answer is yes, and should propel the client into planning questions.

III. VALUATION: LEMON OR LUXURY CAR?

Now that the business owner is ready to plan, she must evaluate the worth of her businesses. Since most owners like where they are, they tend to overvalue the business.

A. Several Valuation Methods Exist To Assist The Business Owner.

Many owners will attempt to use industry rules of thumb to save valuation expenses. This method will get you in the ball park but does not capture unique factors (growth, profitability, intellectual property, etc.) that create large differences in value. The difficulty arising when using the owner compensation valuation method is that the business value will be adjusted on the market rate, but a minority owner's compensation may not be adjusted. Finally, using the value of the Family Limited Partnership interest starts with the basic calculation of Net Asset Value = assets – liabilities. In addition, an owner may often apply a discount up to 20% for lack of control and a discount up to 30% for lack of marketability, if the business fits the valuation discount rules. The preferred method, however, uses a Chartered Financial Analyst (CFA) who has experience with business valuations.

B. When does the client need a formal valuation from a CFA or other qualified professional?

Obtaining a formal valuation for any business worth more than $1 million makes sense. When the goal is to pinpoint delicate issues objectively, such as the importance of the owner in the business, the importance of management and the like, a formal valuation can be helpful. Many owners do not realize the intricacies of valuing businesses and ownership interests, especially those such as applying discounts for illiquidity and marketability; business reputation, including prestige and reknown of the business, ownership of brand or trade name, and record of a successful operation over a prolonged period in a particular locality; earnings and economic benefits; and ascertaining goodwill, although goodwill ascribable only to owner is almost never part of the compensation paid by the buyer, and goodwill not attached to the person is community property.

C. What does a valuation cost?

Valuations obtained from experts generally cost from $2,500 to $50,000, depending on the size of the business and the expert chosen.

IV. PROTECTING THE OWNER'S DESIRES

What does the owner want to do with management? When confronted with having to analyze whether current managers are capable of stepping up to higher positions, most owners have good judgment, even with their own children. Forecasting what management is capable of and what the owner wants for top management is an important part of the analysis.

Many owners addressing the issues of sale and succession talk in terms of selling the business to be free of the hassle and difficulty of owning and running a business. Many of these businesses are mature and stable enterprises that could theoretically be placed in a "harvesting" mode, that is, in a mode that the business could be milked for its profits. Associated with this theoretical concept is the owner slowing down and changing his or her role to that of a primarily strategic, non day to-day role. While the concept sounds fine, most entrepreneurs cannot actually execute such a plan because of their inability to let go of the business and share authority with a strong operational manager, family or not.

V. PUTTING THE PLAN TOGETHER

Successful business succession planning requires (1) easily transferable assets among family, (2) a plan for a smooth transition of power, and (3) a method for reducing the tax burden on the family's business assets at death. The key to achieving these goals is to establish estate planning structures for the family. By the term "structures" we mean entities that will enable the parents to transfer assets and decision-making authority to the next generation when they see fit and help to reduce the tax burden on the family's business. There are a wide range of entities that can be employed in the pursuit of effective succession planning, but, for the purposes of this paper, family limited partnerships (FLPs) and limited liability companies (LLCs) will be used as the primary examples. However, FLPs and LLCs are not meant to be the exclusive entities used to create structure for the family's business succession plan.

A FLP is a structure designed to manage and hold one or more business assets for a family. The FLP can be drafted to hold the assets as limited partnership interest. These interests become the family business assets instead of oil and gas operating interests, real estate or securities, for example. The operating interests, real estate and other assets are held by the partnership and the liability is, in turn, held by the partnership's general partner. The general partner is usually an LLC. The LLC is usually capitalized with liquid assets and owns a one percent general partnership interest in the FLP. The managers of the LLC run the day-to-day operations of the FLP and make the key business decisions involved with the business assets held by the FLP. FLPs are designed to hold business assets or business interests directly, to avoid divided ownership interest in each asset, and to streamline management issues.

How would such an FLP and LLC be structured? If the parents own a business they could form the LLC by contributing cash to the LLC, and the LLC uses that cash to purchase a one percent general partner interest in the FLP. They would each own 50% of the general partner's membership interest. The ownership in the LLC would entitle them to make key business decisions regarding sales, acquisitions, and cash distributions for the FLP. The parents would have already conveyed their business and its assets to the FLP. They then would each own an undivided 49.5% interest in the FLP[1]. Their ownership of the FLP limited partnership interests would entitle them to distributions of cash, if any are made. The limited partners, being limited of course, would not be making day –to-day business decisions and so would be insulated from the liability to which the general partner is subject. This protects the family business and also creates an opportunity for the parents to introduce the children to the family business by introducing them as limited partners of the FLP, but not as members of the LLC.

Including the children in the family business isn't just about an inheritance; it's about gradually passing on the responsibility and authority that comes with owning a business. By having an FLP and LLC established and funded, the transfer can occur when

[1] presuming community property rules apply and that the property funded is not separate property

the parents are comfortable. The parents can gift or sell the business interests to their children during their lifetime. Of course, the transfer can also occur at death. The transfer itself can occur either as a mere entitlement to benefits from the business or as a right to direct the course of the business itself.

Transfer restrictions are a key aspect of these structures, because they ensure the course of the business. Without the restrictions, the parents would find that they would have created unintended leverage for the children to control company decisions. The FLP interests are subject to a first offer to other limited partners before a sale, gift or other transfer is allowed to an outside party. However, if a transfer is contemplated to certain "permitted transferees" then the transaction is permitted. Those transferees can be anyone the parents decide it can be: descendants, spouses of descendants, cousins, siblings, et cetera. With these restrictions in place, the ownership of the business is restricted to certain people and any transfer outside the family are subject to a right of first refusal by the family. These restrictions stabilize the family business for future generations.

Another transfer restriction to consider is that when an interest in a family limited partnership is transferred it is only as an assignee interest and not as a full partnership interest or full membership interest. A transfer of a family limited partnership interest to a non-partner confers only the rights of an assignee interest, and the assignee must be admitted as a limited partner under the terms of the FLP in order to obtain full partnership benefits. By gifting assignee limited partnership interests, the parents can gradually give away the right to mere distributions of cash or other assets if they decide to as the managers of the LLC. The children have no say so as assignee interest holders. Later, of course, the parents may decide it is time to admit the children as full limited partners, which would give them more authority over the direction of the partnership, while still limiting their access to running the business. They would be included in matters involving the business but still would not be able to direct the course of the business. The parents could make gifts of the LLC membership interests or perhaps name the children as managers of the LLC which would give them the right to a salary, employee benefits, full say in the direction of the family business and hands on experience in how the parents run things.

Transfer restrictions are a key aspect of these structures, because they ensure the course of the business. Without the restrictions, the parents would find that they would have created unintended leverage for the children to control company decisions. The FLP interests are usually subject to a first offer to other limited partners before a sale, gift or other transfer is allowed to an outside party. However, if appropriate restrictive language is used, a transfer can be limited to certain "permitted transferees." Those transferees can be anyone the parents decide it can be: descendants, spouses of descendants, cousins, siblings, et cetera. With these restrictions in place, the ownership of the business is restricted to certain people and any transfers outside the family are subject to a right of first refusal by the family. These restrictions stabilize the family business for future generations.

While these structures help accomplish two of the primary goals of successful business succession planning, namely ease of transition of power and easily transferable assets among family, the establishment of an FLP and LLC does not guarantee a reduction in the overall tax burden placed upon the family business or the parents' estates at death. It is possible that the hoped-for valuation discounts will be denied by the IRS, and, increasingly, family limited partnerships have come under greater scrutiny by the IRS as to whether they exist as a true family business or a mere holding entity.

Before further planning options can be pursued, the FLP and LLC must be properly maintained and used. At a minimum this means, all the annual meetings and the attendant annual consent minutes and other documentation recording all the matters of business must be completed on an annual basis. This requirement covers all manner of business that can easily slip through the cracks. For example: The registered agent for service of process must be properly maintained. The officers and managers must be elected annually. The tax returns must be presented to the limited partners for review from the general partner. The names of the company and partnership must be maintained with the secretary of state. Taxes must be filed and paid appropriately given the FLP and LLC. Obviously, the appropriate bank accounts must be established and honored as business accounts, and not as personal spending accounts. Of course this makes sense, but for certain clients this is more planning than they are willing to accept and for these clients an FLP and LLC are not appropriate planning structures. Essentially, the business must be run like a business or else it will be treated as a straw man by the IRS. If that happens, there will be no reduction in taxes whatsoever, and any additional planning you have been able to accomplish using the FLP and LLC will be in serious jeopardy.

Making gifts of family limited partnership interests creates some tax benefits. A gifted interest has the same basis as it had in the gift giver's hands. Making a gift has the advantage of reducing the giver's gross estate for federal estate tax purposes and can possibly occur free of gift tax (if total lifetime giving is under $1 million, under current law). The LLC and FLP are pass-through entities, and the partners and members pay their own taxes. Other entities have different tax schemes. An advantage to forming an FLP, but certainly not the sole reason for forming one, is that is has the effect of dividing business interests and thereby creating valuation discounts.

The FLP and LLC provide liability protection for the family business. The limited partners are not personally liable for the expenses, liabilities or obligations of the FLP. The general partner, the LLC, is personally liable for the expenses, liabilities and obligations incurred by the FLP. Because of this structure, you are able to separate ownership from personal liability, which is a valuable planning tool when passing down ownership interests to the next generation, but not wanting to burden them with responsibility or liability.

The FLP and LLC are mere starting structures. Once they have been established, the partnership interests and membership interests can be used in transfers with other structures. An intentionally defective grantor trust can be used to facilitate moving family business assets down a generation while freezing the gross estate and allowing the growth of the business to occur free of gross estate tax and generation skipping transfer tax. An intentionally defective grantor trust is similar to most irrevocable trusts except that it contains a provision which causes it to be treated as owned by the grantor for income tax purposes but not for estate tax purposes. Because this trust has unusual tax features it is useful for transferring assets down to the next generation. The parents create the trust and gift a certain amount of seed money needed to purchase a portion of the family business. When they make this gift, they file a form 709 recording the gift and ensuring that the appropriate GST exemption is allocated to the trust assets. The children are the trustees and primary beneficiaries of the trust. They can then use the seed money to purchase assignee family limited partnership interests on an installment basis. There are numerous tax angles that can be pursued with such a structure. None of them are guaranteed to always produce a favorable outcome, and the client and the attorney both need to use caution when exploring the use of an intentionally defective grantor trust. However, with careful use such a trust has the potential for very favorable results.

A mere complex trust can also be extremely useful in transferring limited partnership interests to the next generation. Consider the benefits of transferring family interests to a spendthrift trust created for the benefit of each child. Each child has their own trust from which they derive benefits, each trust is protected to a certain extent from creditors (of course until a distribution is made), and each of the trust's wealth can grow free of estate tax at the grantor's death and at the children's death. If GST exemption is available, such a trust could be extremely useful for corralling assets with a strong growth potential to avoid GST at the child's death. Even if all of these benefits are uninspiring to a client, consider that at a minimum the child would be protected from overspending the income from the family interest. The trustee would make distributions for health, education, maintenance and support. Careful selection of a trustee can make this distribution standard more or less permissive. By permissive, we mean that the selection of a bank as trustee (if the bank is willing to serve) would make the distribution standard less permissive. Banks and other trust institutions tend to be more restrictive in their distributions. The selection of another family member or the child as a non-independent trustee can make these standards more permissive.

A family with numerous business entities must consider the possibility of creating more than one family limited partnership and LLC. For instance, a family that has accumulated wealth from oil and gas operating interests as well as securities should consider creating an Oil and Gas, Ltd., as well as a Securities, Ltd. entity. The further specialized the partnerships are, the easier it is to maintain the business of managing them. Additionally, it becomes easier to give specific control to different children in the family. If one child seems to be more interested in Oil and Gas, then it make more sense to only gift assignee limited partnership interests of Oil and Gas, Ltd., to them. For other children, a gift of an interest in the Securities, Ltd., can provide an income stream and a means of equalizing treatment among very different children.

By using FLPs and LLCs in conjunction with many different kinds of trusts, the family can begin the process of handing down the family business on a gradual basis all the while providing useful planning tools for the attorney to use as the family's goals change over time. With the proper structure established, the family can broaden their estate and tax planning, or decide to minimize the amount of planning they wish to be involved in. The key is to establish structure early and to be certain to allocate tax exemptions to the proper entities prior to the big growth that can occur. Although it can be overlooked, it cannot be emphasized enough, having a CPA who is familiar with estate tax, gift tax and generation skipping tax is extremely important to the family and to the attorney.

VI. TAX DEFERRAL STRATEGIES AND OPPORTUNITIES

This Section taken from CLE article "Sales of Closely-Held Businesses: Shareholder Exit Strategies and Resulting Tax Consequences" by Anne A. Trinklein submitted at State Bar of Texas Summer School, July 28, 2000, Galveston, Texas

A. Reorganizations.

If the selling shareholder is interested in acquiring a continuing equity interest in or has interest in a purchasing corporation or if a corporate buyer wants to acquire the selling shareholder's entire business, then the parties may attempt to qualify for a "tax-free reorganization" under Internal Revenue Code Section 368.

The general rule for a sale of property is that gain or loss is recognized if the acquired property is materially different from the exchanged property. The purpose of the reorganization provisions of Code

Section 368 is to allow specific types of of a continuing interest in property to proceed tax-free. In order to qualify as a tax-free reorganization, the transaction generally must satisfy the statutory requirements of a specific reorganization technique and involve (1) continuity of the business enterprise, (2) continuity of interest in the new corporation, and (3) a bona fide business purpose.

B. Recapitalization.

Another type of corporate reorganization technique that may be useful in the case of a family-owned business is a recapitalization (Type "E" Reorganization).30 A corporate recapitalization in this context replaces a corporation's one class of stock with two (or more) classes: (1) preferred stock (with a priority right to a certain amount of corporate earnings and possibly voting control), and (2) common stock (with a right to corporate earnings and liquidation capital the amounts that are granted to preferred shareholders, including the right to the future appreciation in the net value of the corporation.) In a family-owned business, the older generation shareholder (the "parent") may keep the preferred stock and leave the younger generation shareholders (the "children") with the common stock. If the recapitalization qualifies as a Type "E" Reorganization, income tax on the appreciated value of the surrendered stock and/or securities will be deferred until the stock and/or securities are later disposed in a taxable transaction. The result of this re-shuffling of ownership interests among shareholders is that the parent may be able to retain a stream of retirement income and voting control in the family business while passing the management responsibility to his or her children at a reduced income tax cost. In addition, to the extent that future appreciation in the value of the business is removed from the parent's estate, the parent may be able to pass a significant portion of his estate to his children at a reduced transfer tax cost.[2]

C. Sale to an ESOP.

An Employee Stock Ownership Plan ("ESOP") is a qualified employee benefit plan under Section 401(a) designed to invest in qualifying securities of the corporation that forms the ESOP. A sale to an ESOP offers the shareholder the opportunity to reinvest highly-appreciated illiquid stock into more liquid investments without incurring capital gains tax.35 A shareholder may defer recognition of any capital gain on sale of closely-held stock to an ESOP as long as the selling shareholder purchases "qualified replacement property" within a certain time period and makes an election for Code Section 1042 to apply.36 The seller's cost basis in the replacement property is reduced by the amount of the unrecognized gain, and the tax on the capital gain is deferred until the qualified replacement property is disposed of in a sale or exchange.

D. Private Annuity.

A private annuity is an arrangement where the obligor/successor business owner, who is not in the business of writing annuities, agrees to pay an annuitant/business owner a lifetime annuity in exchange for the transfer of shares in the company. This technique is useful in a family-owned business because it allows family members to pay the purchase price over time (similar to an installment sale) rather than to come up with the full price for the shares at the time of the transfer. Since the annuity terminates at the death of the annuitant, the annuity will not be includible in the annuitant's gross estate for estate tax purposes under Code Section 2039. In addition, if the annuitant transfers his entire interest in the stock in exchange for an annuity "for full and adequate consideration in money or money's worth," no portion of the transferred stock will be includible in the annuitant's gross estate under Code Section 2036. The annuitant/business owner will recognize any gain in the stock over time as ordinary annuity income rather than all at the time of the transfer. If done successfully, the use of a private annuity allows a

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[2] Special care must be taken when a family-owned corporation uses this technique because the valuation rules of Chapter 14 of the Code may apply to the recapitalization. If a shareholder transfers corporate stock to a member of the shareholder's family and retains any "retained" interests@ that are not excepted from the application of Code Section 2701, the parent will be deemed to have made a taxable gift at the time of recapitalization to his or her children equal to the full fair market value of the transferred stock without a reduction for the retained interests.32 In addition, the lapse or termination of voting or liquidation rights in a corporation may result in a taxable transfer for gift and estate tax purposes under Code Section 2704. As a result, a preferred stock recapitalization may not be particularly useful in a closely-held corporation unless the transaction is carefully structured so that the Chapter 14 valuation rules do not apply.

selling shareholder to recognize gain over time as business owner the opportunity to remove future appreciation of stock out of his or her estate with no gift or estate tax cost.[3]

E. Installment Sale.

If a noncorporate shareholder of a corporation who uses the cash method of accounting sells his or her stock to a third party in exchange for a note that is paid in installments over more than one year, the sale may qualify for installment reporting under Code Section 453. If so, each installment payment will be treated as part recovery of basis and part gain. This allows the selling shareholder to recognize gain over time as payments on the note are actually received rather than recognizing all the gain at the time of the sale.

F. Sale to an Intentionally Defective Grantor Trust.

An "intentionally defective grantor trust" is a trust that is treated as owned by the grantor for income tax purposes, while transfers to the trust are complete for gift and estate tax purposes. An installment note or a private annuity is sometimes used in connection with a sale to a defective grantor trust. The sale is disregarded for income tax purposes because the trust property is treated as owned by the grantor and no gain is recognized on a sale to oneself. Interest payments on the note are also disregarded so there is no income received by the grantor/seller and no deduction allowed to the trust. As long as the interest rate is higher than the Applicable Federal Rate at the time of the transfer and the sales price is at least the fair market value of the property sold to the trust, there will be no gift tax consequences to the grantor/seller at the time of the transfer. Depending on the type of note, if any, used as consideration for the sale, the value of a note outstanding at the time of the grantor's death may be included in the grantor's estate if the grantor/seller dies during the term of the note. However, the value of any property transferred to the trust will not be included in the grantor's estate for estate tax purposes.

G. Exclusion of Gain on Sale of Certain Small Business Stock.

When a noncorporate shareholder sells certain small business stock that the shareholder has held for more than five years, fifty percent of any gain from the sale or exchange of such small business stock will be excluded from the shareholder's taxable income. The gain eligible for the exclusion is the greater of ten million dollars reduced by the aggregate amount of eligible gain taken into account by the taxpayer in prior taxable years and attributable to dispositions of stock issued by the corporation, or ten times the aggregate adjusted bases of qualified small business stock issued by such corporation and disposed of by the taxpayer during the taxable year.51 This exclusion generally is not available to service industry businesses.52

H. Rollover of Gain from Sale of Qualified Small Business to Stock of Another Small Business.

If a noncorporate taxpayer sells A qualified small business stock@ held by that taxpayer for more than six months, the taxpayer may elect to rollover the gain from the qualified small business stock to another qualified small business stock purchased within sixty days from the sale of the previously owned stock (a Code Section 1045 rollover), and thereby defer recognition of capital gain until the sale or disposition of the newly-acquired stock.53 Gain will be recognized to the extent the sale proceeds exceed the cost of any qualified small business stock purchased by the taxpayer within sixty days of the sale, reduced by any portion of such cost previously taken into account for purposes of an earlier Code Section 1045 rollover. A qualified small business stock is the same as qualified small business stock under Code Section 1202. The shareholder's basis in the newly acquired qualified small business stock is reduced by the amount of gain deferred in the rollover.

I. Step-Up in Basis for Transfers at Death.

Although holding stock until death also is not a "sale" technique, a business owner with highly appreciated stock should be aware of the potential income tax advantages to his or her family of testamentary transfers of the stock. If a shareholder holds stock until death, the taxpayer who inherits the deceased shareholder's stock gets a new basis in the stock equal to the fair market value of the stock on the date of the decedent shareholder's death. This eliminates any pre-death gain or loss on a subsequent sale of the stock.61 Although it may be tax efficient

[3] There are a number of risks inherent in the use of a private annuity. First, there is a risk that the Internal Revenue Service will attempt to re-characterize the annuity arrangement as a transfer with a retained life interest instead of a sale for adequate and full consideration. If the Service is successful, the stock will be included in the business owner's estate at his or her death.41 To protect against this risk, a business owner should always obtain an independent appraisal to support the value used. Second, if the annuitant outlives his or her life expectancy, the obligor will be required to continue to pay the annuity and therefore will eventually pay more than the property's fair market value at the time of the transfer. This result would frustrate the business owner's effort to reduce the size of his or her estate through the use of the annuity arrangement, but would ensure a continued income stream to the retired business owner for the remainder of his or her lifetime.

from an income tax perspective for a shareholder to hold appreciated stock until death, it may not be an optimum strategy from a transfer tax perspective since the fair market value of the business interest at the date of the shareholder's death will be included in the deceased shareholder's estate for estate tax purposes.

VII. CHARITABLE STRATEGIES FOR TRANSFERRING A CLOSELY HELD BUSINESS AT DEATH

This Section taken from CLE Article "Sophisticated Charitable Planning: Helping Your Clients Achieve Their Charitable Goals On A Tax-Enhanced Basis" by Cheryl Cain Crabbe at State Bar of Texas 30th Annual Advanced Estate Planning And Probate Course, June 7-9, 2000, Houston

A. In General

Testamentary charitable planning for a closely held business owner is also complex, but in the right circumstances, can help a business owner keep control of the business within the family, while minimizing estate taxes and benefiting charity. Charitable entities typically utilized in relation to testamentary charitable planning are the private foundation and the CLT. CRTs are not generally used in testamentary planning for the closely held business, though they can be very effective in passing a business to the next generation during lifetime (by example, the charitable stock bail-out with C corporation stock, discussed above). Testamentary charitable planning strategies are inherently less transfer tax efficient than lifetime strategies, but they certainly can provide an efficient method for business owners who either will not give up control during life or whose business has become so valuable that lifetime strategies, even if utilized, cannot sufficiently remove the entire business from the estate.

B. Fact Pattern

Client is a business owner who, like many owners, is intent on maintaining full control over and beneficial enjoyment of his business during lifetime. His needs for control and enjoyment have hampered him from using lifetime transfer strategies, such as gifting, redemptions, charitable stock bail-outs (as discussed in the preceding section), grantor retained annuity trusts and installment sales, to efficiently transfer the business to his children. He now wants to integrate testamentary business succession planning in his estate plan, as well as further charitable giving. He either already has an ongoing private foundation which is operated, primarily, by his children, or he plans to create one upon his death.

C. Bequest of Business to Private Foundation – Thwarted Family Control of Business

Client suggests leaving the business to his private foundation, thinking that his children (as managers of the foundation) could, in turn, control the business after his death. If he were to do so, however, family control of the business will be thwarted by the private foundation excise tax rules, particularly those concerning self-dealing and excess business holdings, as discussed above and further below.

As discussed above, a private foundation's ownership of a family business interest can be very problematic. That said, a bequest of a family business to a private foundation, or a CLT for that matter, can help a client achieve his business succession, estate tax minimization and charitable giving goals, if it is coupled with another strategy (rather then merely being a bequest of the business to the foundation or CLT). Some of these strategies may include: (a) a bequest of a business interest to a private foundation or CLT coupled with a corporate redemption of the charitable entity's interest shortly after death; (b) a bequest of a business interest to a private foundation subject to an option in the family to purchase the business interest from the estate (prior to being distributed to the foundation); and (c) a bequest of a business interest to a CLT subject to the family's option to purchase the interest from the owner's estate (again, prior to being distributed to the CLT). Each of these strategies is discussed below.

D. Redemption by Business - Exception to Self-Dealing Rules

The general redemption exception to the self-dealing rules can be a useful planning option if it is anticipated that the owner's business will have a lot of cash shortly after the owner's death. Under this strategy, the owner could bequeath an interest in his business to a private foundation, CLT or CRT. If the recipient charitable entity is properly designed, the estate will be entitled to a charitable deduction for the value of the business interest passing to charity. If the business redeems the charitable entity's interest in the business, the problems otherwise presented by the excess business holdings, self-dealing prohibitions and UBTI can be avoided. The charitable entity ends up with cash, while the family ends up in control of the business.

1. <u>General Redemption Exception</u>

Recall, that if an interest in a decedent's business is owned by a private foundation, CLT or CRT, the corporation is a disqualified person. I.R.C. §§ 4946(a)(1)(E), (F) and (G). As such, ordinarily, the corporation's redemption of the charitable entity's stock will trigger excise tax under the self-dealing prohibitions of Section 4941. An exception from self-dealing exists, however, if the corporation offers to redeem all securities of the same class as that held by the charitable entity and upon the same terms, and those terms provide that the charitable entity shall receive no less than fair market value for its stock. I.R.C. § 4941(d)(2)(F).

2. Cash Redemption, Rather than with Note

The corporation will need to have ample cash available, and should not fund the redemption with a promissory note to the foundation. Although if properly structured as noted above, the redemption, itself, is excepted from the definition of self-dealing, the note could constitute a separate act of self-dealing I.R.C. § 4941(d)(1)(B).

3. Separate Class of Stock

If a redemption pursuant to Section 4941(d)(2)(F)'s general redemption exception is contemplated, the corporation can issue a separate class of stock. Then, the business owner can use that class of stock as the subject of all charitable gifts (lifetime and testamentary) to the intended charitable entity (foundation, CLT or CRT), with the result that stock owned by other individuals or entities will not have to be included in the business's ultimate redemption of the charitable entity's stock under the general redemption exception from the self-dealing rules under Section 4941(d)(2)(F) redemption.

VIII. AFTER DEATH: THE §6166 ELECTION

> **This Section taken from CLE Article "The Who, What, And How Of §6166" by Bethann Eccles, Jd, Cpa at State Bar Of Texas 30th Annual Advanced Estate Planning & Probate Course, June 7-9, 2006, Houston**

For years now, we've heard the political byline that estate taxes are ruining the family-owned small business. §6166 remains a powerful tool for protecting these businesses by postponing the payment of the estate taxes attributable to ownership of a closely held business, allowing a taxpayer's surviving family members to retain and maintain the business enterprise for future generations, without forcing the family to "sell the farm."

When Internal Revenue Code §6166 was enacted in 1958, Congress reported:

> "This provision is primarily designed to make it possible to keep together a business enterprise where the death of one of the larger owners of the business results in an imposition of a relatively heavy estate tax. Where the decedent had a substantial portion of his estate invested in the business enterprise, under existing law this may confront the heirs with the necessity of either breaking up the business or selling it to some larger business enterprise, in order to obtain funds to pay the federal estate tax…. Therefore, although not removing any federal estate tax in these cases, your committee hopes that by spreading out the period over which the estate tax may be paid, it will be possible for the estate tax in most cases to be paid for out of the earnings of the business, or at least that it will provide the heirs with time to obtain funds to pay the federal estate tax without upsetting the operation of the business. Your committee believes that the provision is particularly important in preventing corporate mergers and in maintaining the free enterprise system." H.R. Rep. No. 2198, 85th Conf. 2d Sess. (1958).

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