Planning for Owners of Closely-Held Businesses

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Unique Nature of the Estates of Many Entrepreneurs

- Often, closely-held business interests are a substantial portion of net worth
  - Hard to value
    - Advantages and disadvantages
  - Illiquid
    - How do you pay the tax?
  - Not easily divisible among heirs
    - Who will control after you are gone?
    - Who is active and who is not?

Unique Nature of the Estates of Many Entrepreneurs

- Equalization – is it even possible?
- How do you avoid family litigation?
- Often operated informally – much clean-up work to do
- Voting and non-voting and close corporation (and operating) agreements – pre-death and post-death

Unique Nature of the Estates of Many Entrepreneurs

- “S” corporation challenges after death
  - Maintaining the “S” election
    - Timing of QSST or ESBT elections
    - How to get that basis step-up inside

Unique Nature of the Estates of Many Entrepreneurs

- Non-tax issues for entrepreneurs created by common planning techniques
  - SLATs and divorce
    - Division of assets
    - What is a marital asset subject to division?

Unique Nature of the Estates of Many Entrepreneurs

- Taxation of SLAT income after divorce - § 682
  - Pre 1/1/2019 divorce decrees –
    SLAT income not taxable to grantor spouse
  - Post 12/31/2018 divorce decrees - § 682
    Protection against grantor status is gone
    - How will Treasury Regs. Interpret this?
    - Grantor beware
    - Educate the divorce lawyer

Unique Nature of the Estates of Many Entrepreneurs

- Personal financial statements and irrevocable trusts
  - Avoiding bank fraud
    (Don't put irrevocable trust assets on your personal financial statement)
  - Avoiding putting SLAT assets at risk
    - Loan Guarantees
    - Representing that these are your assets

Unique Nature of the Estates of Many Entrepreneurs

- Irrevocable Trust ownership of the family business
  (such as DGT's, BDT's, SLAT's, DAPT's)

  - Can the document be open-ended on beneficiary depending on who is in the business?
  - Who can make beneficiary changes?
  - Can beneficiary status be dependent upon being active in the business?

Proper Planning for Entrepreneurs

- Be sure the entrepreneur has basic documents
  - Wills, Revocable Trusts, General Durable Powers of Attorney, Health Care Directives
- Title assets so as to avoid probate
- Do a liquidity analysis
- Plan for the payment of the estate tax
  - 6166
  - Life Insurance
  - Project increases in value of the estate

Proper Planning for Entrepreneurs

- Recommend Early Gifting
  - Avoid the “Bill Davidson” issues
  - Recap into Voting and Non-Voting. Make gifts of non-voting to multi-generational grantor trusts or SLATS – do it early
  - Trap growth outside of parent’s estates in GST exempt trusts
- Get kids involved through “corporate opportunities”
- Use ILIT’s for life insurance

  (Not sexy but underrated)

Proper Planning for Entrepreneurs

- Trustee Selection
  - Passive v. Active – *Mattie K. Carter Trust*
  - Professional practices and licensing
  - Real estate professionals
  - Dealers and traders

Proper Planning for Entrepreneurs

- The power of grantor trusts for entrepreneurs (practical considerations)
  - Income and Estate Tax free transfers of businesses to next generations
  - Maximum use of generation-skipping
  - Regain basis step-up by swapping assets
  - Toggling and tax reimbursement clauses
  - DGTs, BDTs and SLATs

Proper Planning for Entrepreneurs

- The old standby irrevocable insurance trust (ILIT)
  - Arguably better than a Roth IRA
  - Instant liquidity but if beneficiaries are different in the ILIT than in business assets, you will not be able to use ILIT proceeds to pay estate taxes
    - Are ILITs good vehicles to equalize inheritances?
    - How do you account for premium payments in equalization equation?

Proper Planning for Entrepreneurs

- ILITs (cont'd)
  - Crummey powers
    - Turning them on and off
    - Paying premiums directly
    - Crummey letters
    - *Cristofani*
  - GST considerations

Practical Aspects of Paying the Tax

- 6166 – how to use it without using it
  - Extend the Form 706
  - Calculate the 6166 payment
  - Pay the installments
  - Finish the audit
  - Pay the tax off

Practical Aspects of Paying the Tax

- Advantages
  - No big outlay up front
  - IRS adjustments are less painful
    - Penalties and interest are reduced or eliminated
  - Bargaining tool with IRS

Practical Aspects of Paying the Tax

- Graegin loans can be dicey if not managed
  - Need illiquid estate with cash or borrowing power in a closely-held business
  - Calculate the tax
  - Business lends the estate the shortfall in liquidity with an interest and principal balloon payment for up to 15 years
    - Fixed in amount
    - Not pre-payable

Practical Aspects of Paying the Tax

Graegin Loans (cont'd)

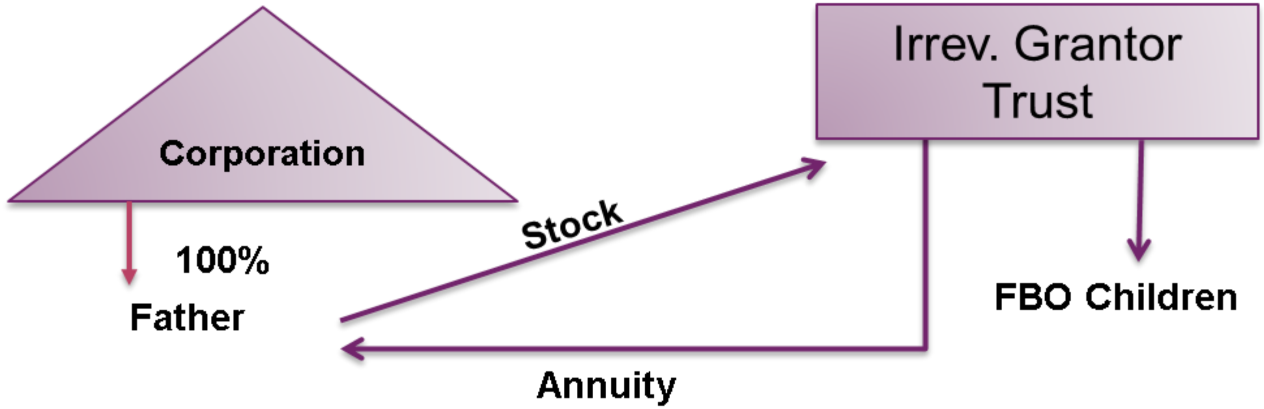
- 15 years (or negotiated terms with IRS) of interest is deductible on Form 706
  - Reduces the tax
- Problem: IRS does not like these, but once signed, it is not pre-payable
- Therefore: Wait until the tax is determined, and then negotiate the Graegin loan with the agent
- Beware: OID rules require the family business to pick up interest annually

Practical Aspects of Paying the Tax

- Section 6161 extensions of payment with interest
  - Usually good for 3 years – one year at a time

Techniques to Transfer Closely-Held Businesses Tax Efficiently

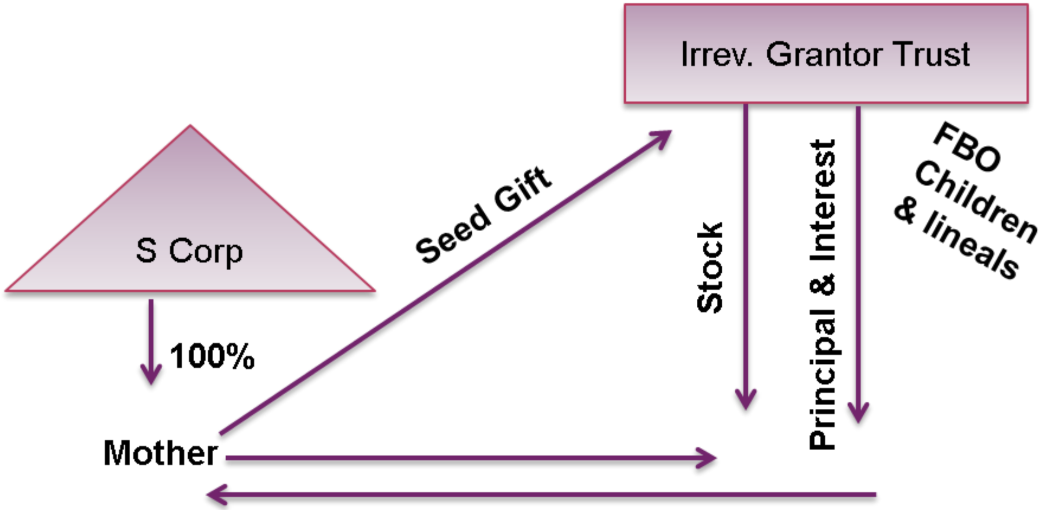
Grantor Retained Annuity Trust



1. Annuity replaces parent's salary
2. Parent may continue to work for company
3. Parent taxed on S corporation income – RR 85-13
4. K-1 in excess of annuity ends, grantor trust can continue for estate reduction
5. After annuity ends, grantor trust can continue for estate reduction
6. Tax reimbursement clause – RR 2004-64
7. Mortality risk
8. GST issues
9. Zero out

Techniques to Transfer Closely-Held Businesses Tax Efficiently

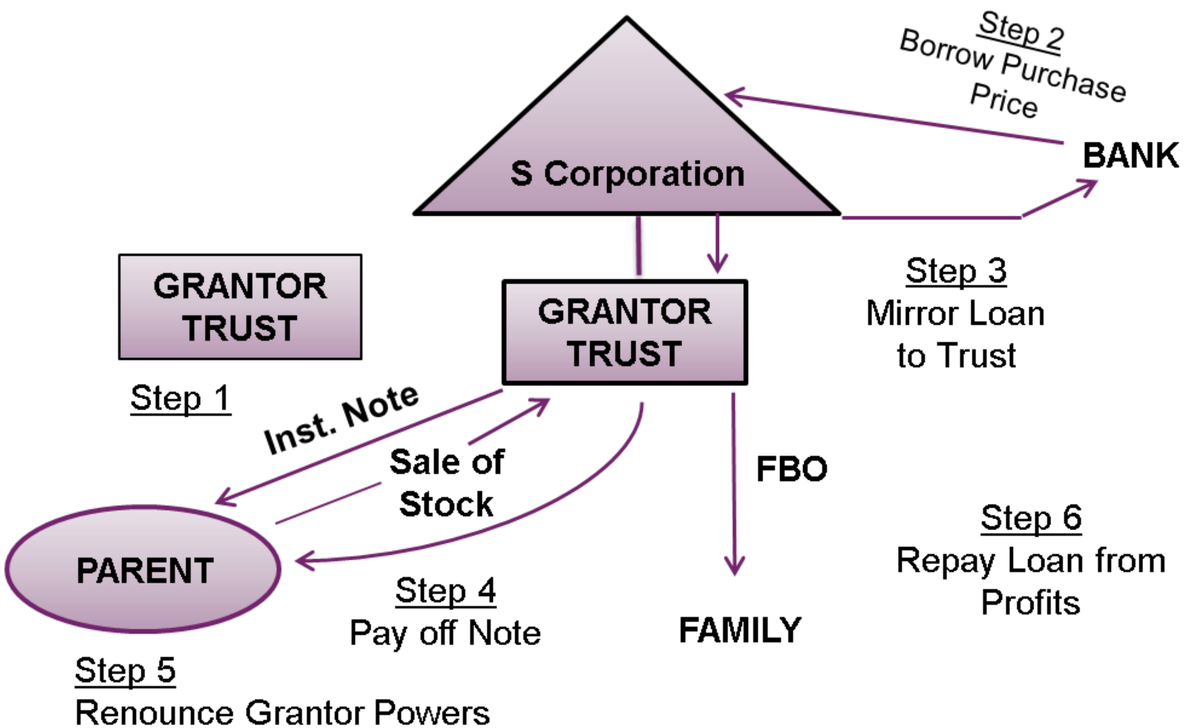
Sale to Grantor Trust



1. Note repayment replaces parent's salary (formula sale – King case)
2. Parent may continue to work for company
3. Parent taxed on S income – RR 85-13
4. K-1 in excess of note payment creates reduction of parent's estate by tax due on income
5. After note payments end, grantor trust can continue for estate reduction
6. Tax reimbursement clauses RR 2004-64
7. Seed money
8. GST issues
9. IRS attack
   - *Woebling* case
   - Interest rate on note (Anecdotal)

Techniques to Transfer Closely-Held Businesses Tax Efficiently

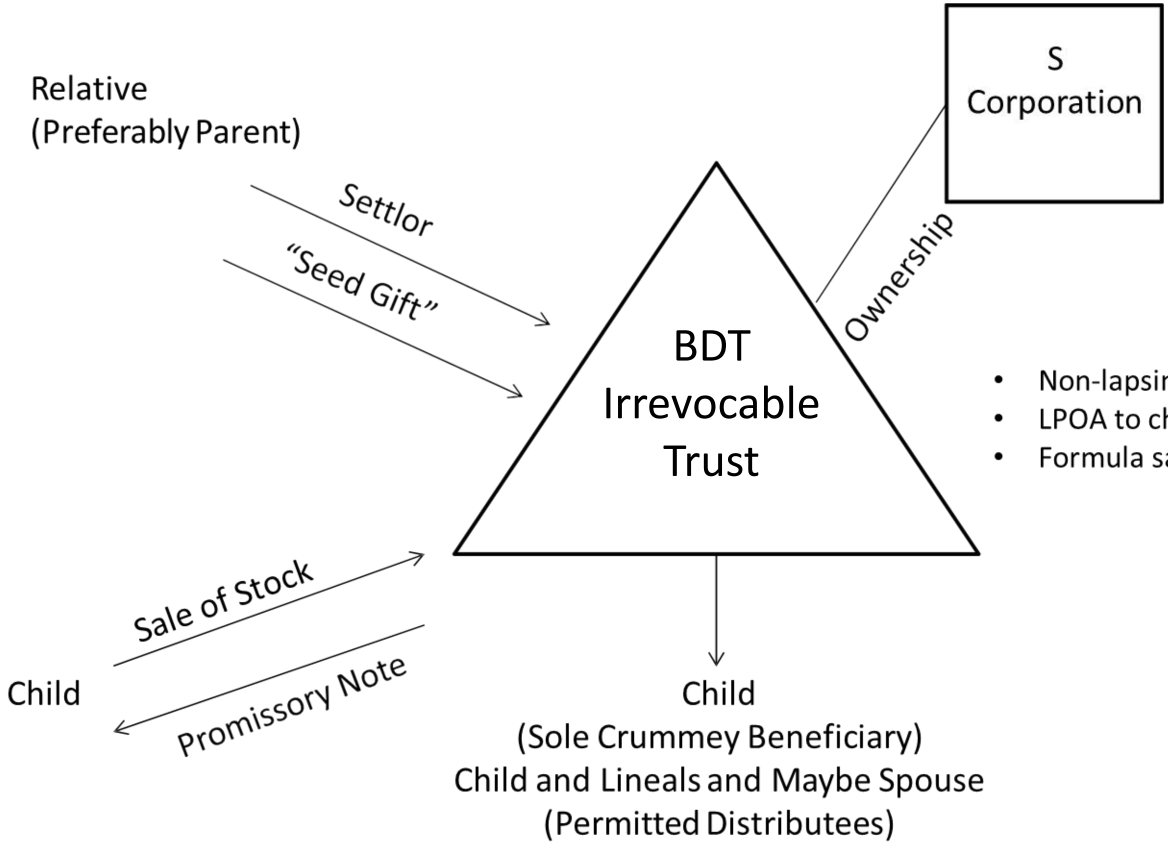
Tax Free Sale to Grantor Trust



Results:
- Parent sells without tax
- Child gets basis in stock
- Parent takes less money for stock

Techniques to Transfer Closely Held Business Tax Efficiently

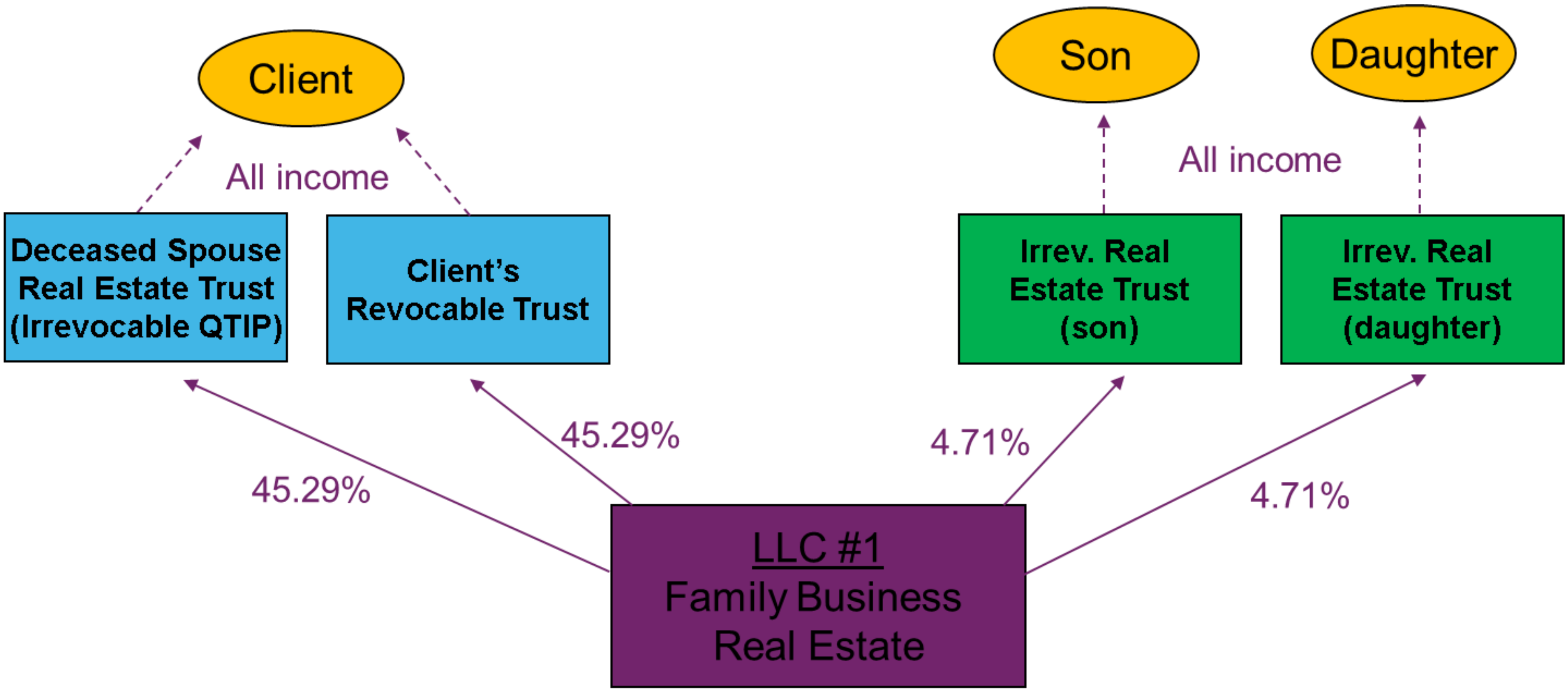
Sale to Beneficiary Defective Trust



- Non-lapsing Crummey
- LPOA to child
- Formula sale clause?

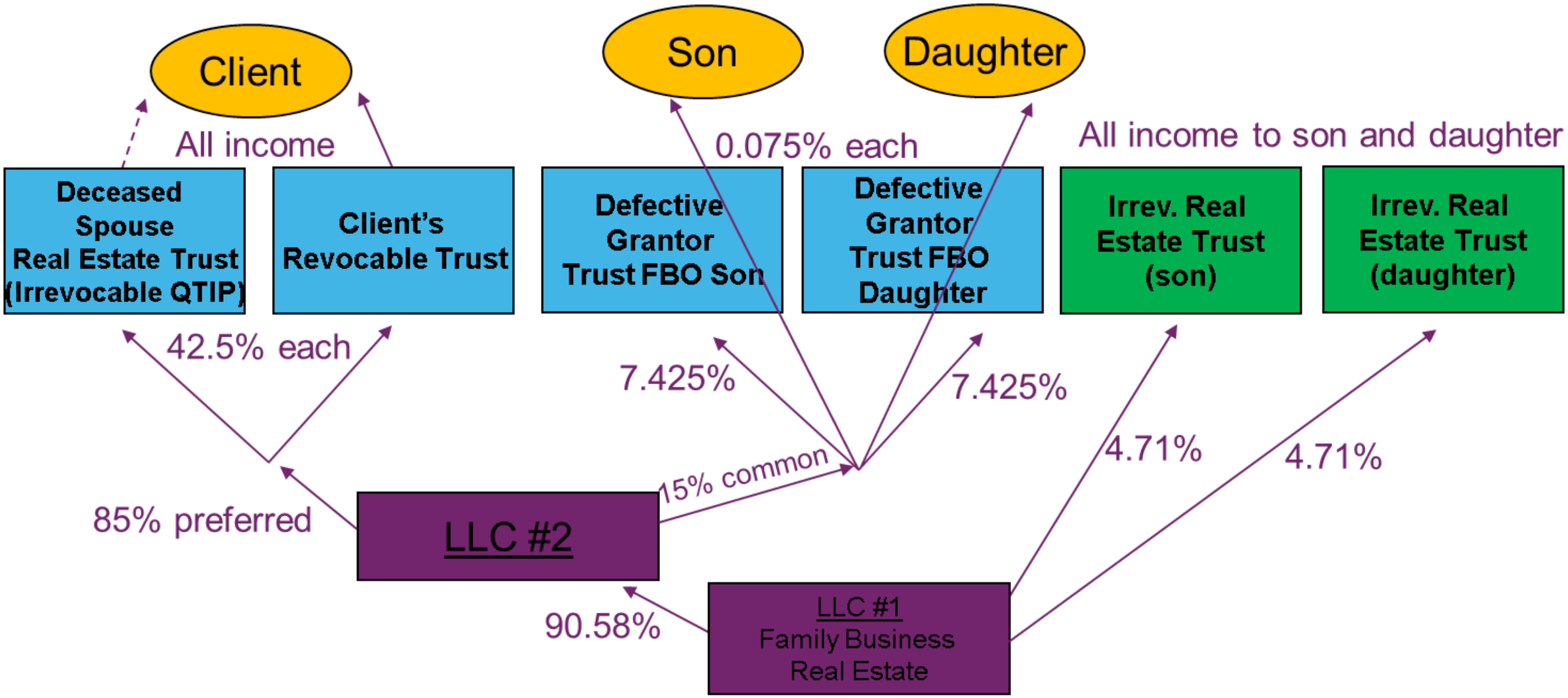
Estate with High Value Negative Capital Account Real Estate

Status Before Transaction



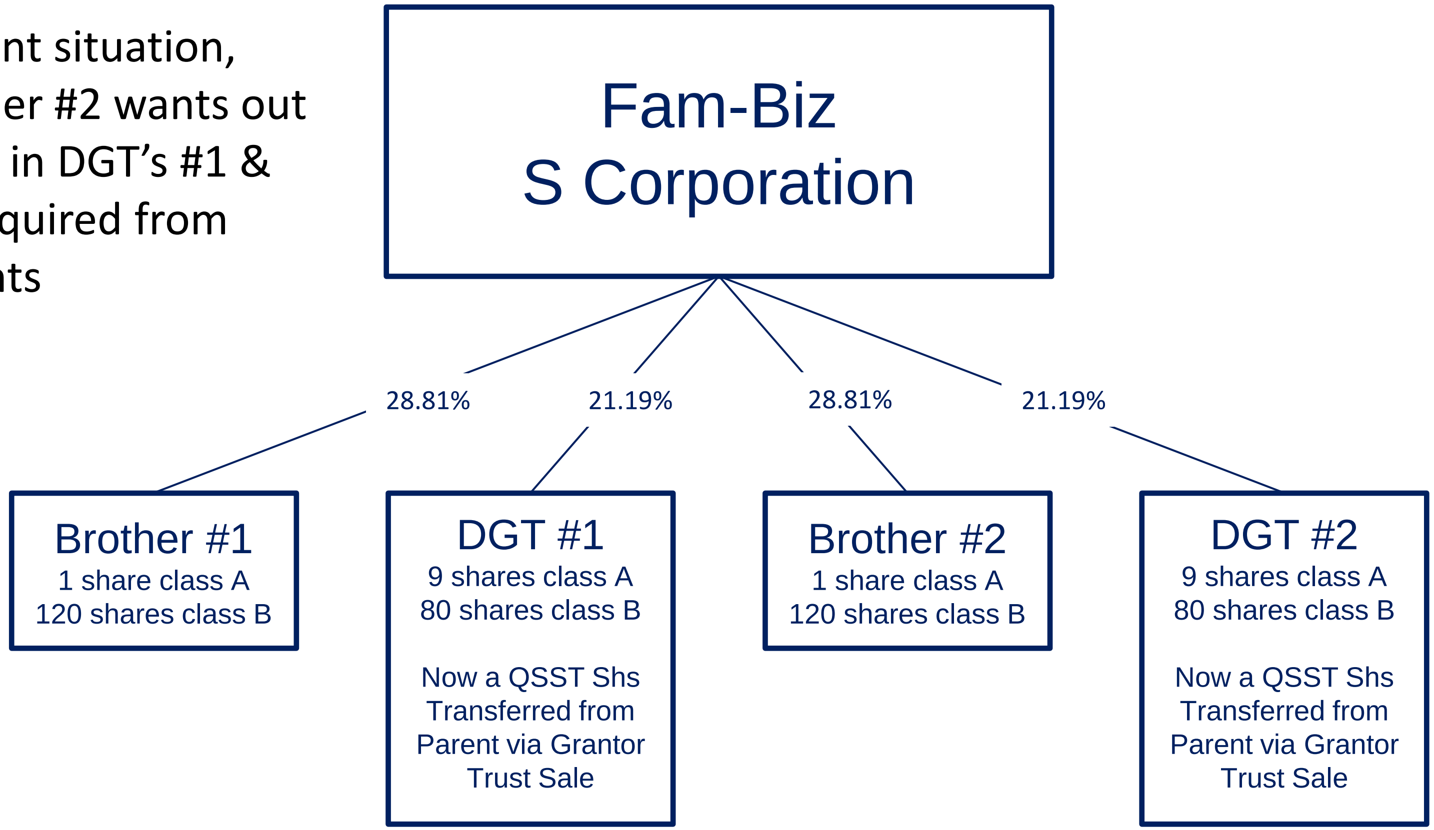
Estate with High Value Negative Capital Account Real Estate

Solution – the Preferred Limited Partnership



Case Study on Intersection of Income and Estate Tax on Family Business Transition

Current situation, Brother #2 wants out Stock in DGT's #1 & #2 acquired from parents



Income / Estate Tax Study (con't)

Current Situation:

1. AAA = $7,300,000
2. Basis B#2 + DGT #2 Shs - $5,539,000
3. E&P = $5,526,774

Steps in tax efficient buyout saving $5.5 Million in tax

1. Redeem $5,539,000 of Shs of DGT#2
2. Flunk §302(b) using option attribution; permits disproportionate distributions RR 89-64
3. Sale by B#2 to new DGT permits an "in effect" tax deductible buyout
4. Sale by DGT#2 in excess of remaining basis is capital gain to the trust
5. B#1 Gets most of his shares into multi-generational trusts

FAM-BIZ, INC.

Summary

	Straight Redemption	Part Redemption, Part Sale to New DGT
Tax to B #2	$ 1,094,275	$ 1,472,578
Tax to B #1	$ 6,610,733	$ 1,236,720
Total Tax	$ 7,705,008	$ 2,709,298
Net to B #2	$ 8,821,825	$ 8,443,522

Sale Price	$ 11,188,000
Salary & Benefits	$ (750,000)
Value of Shares	$ 10,438,000
Value of Shares	$ 10,438,000
5% Retained by B #2	$ 521,900
95% Initial Sales Price	$ 9,916,100
Tax on Income to B #2 (40%)	$ 1,008,808
Tax on Sale by DGT #2 (25%)	$ 463,770
Total Tax to B #2	$ 1,472,578
Initial Sales Price	$ 9,916,100
Total Tax to B #2	$ 1,472,578
Net to B #2	$ 8,443,522

FAM-BIZ, INC.

Complete Redemption

Initial Purchase Price	$	9,916,100	
Tax Basis	$	5,539,000	(42% in Balogh Trust #2 - $2,326,380)
Gain	$	4,377,100	
Tax at 25%	$	1,094,275	

Income to FAM-BIZ, INC.	$	16,526,833
Tax at 40%	$	6,610,733
Net to Pay Note	$	9,916,100

Total Tax	$	7,705,008	=	*$*	*1,094,275*	+	*$*	*6,610,733*
Net to B #2	$	8,821,825	=	*$*	*9,916,100*	-	*$*	*1,094,275*

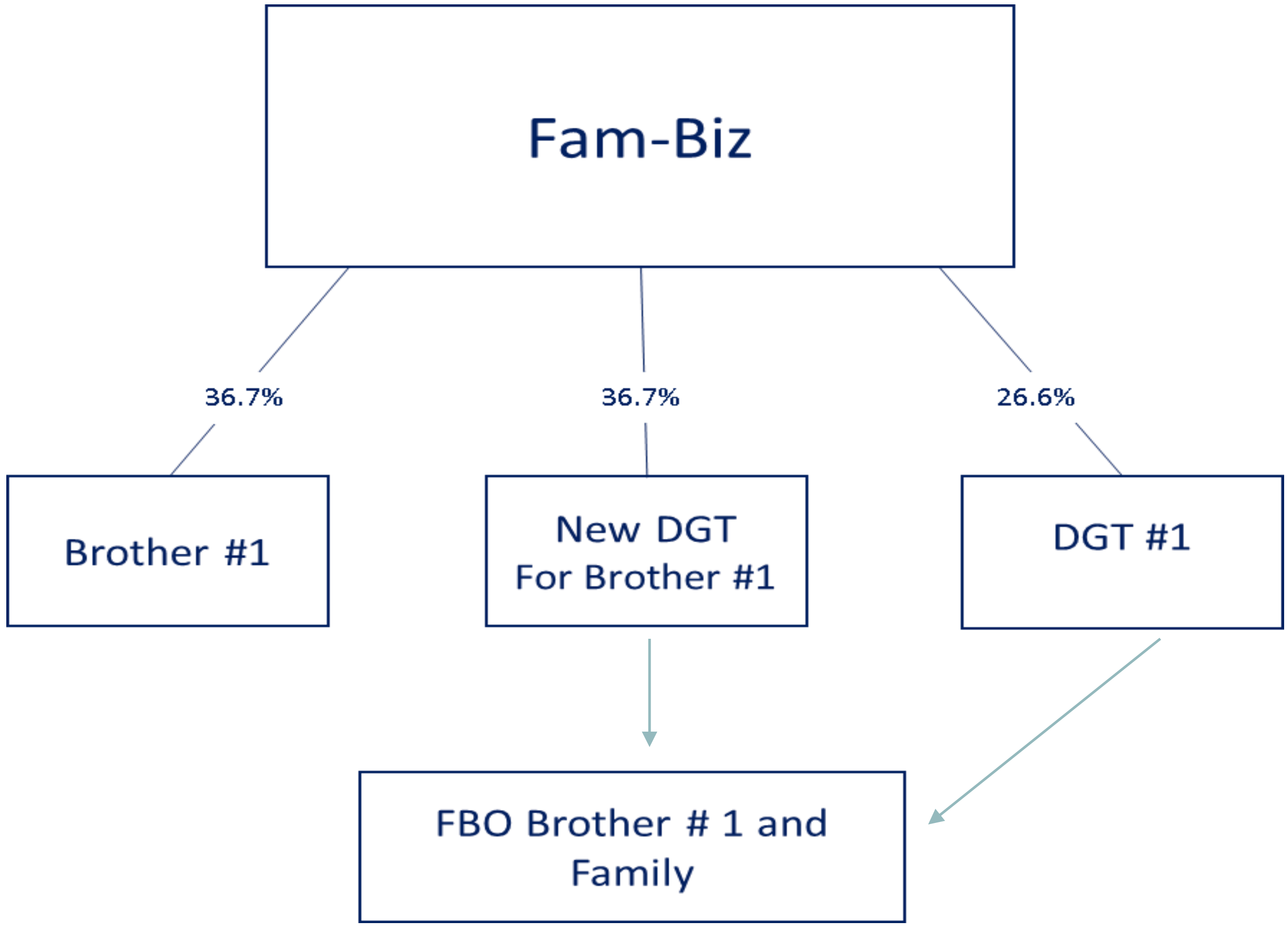
FAM-BIZ, INC.

Redemption Treated as a Dividend Coupled w/ Sale to Grantor Trust

Initial Sales Price	$	9,916,100		
Distribution of AAA	$	5,539,000	301 Distribution of Basis to DGT #2	
Remaining Sales Price	$	4,377,100		
Remaining Tax Basis	$	-		

Sale								
		B #2 57.62%			DGT #2 42.38%			Totals
Sale Price	$	2,522,020		$	1,855,080		$	4,377,100
Basis	$	-		$	-		$	-
Gain	$	2,522,020		$	1,855,080		$	4,377,100
Tax on Income to B #2 (40%)	$	1,008,808	=	*$*	*2,522,020*	*x 0.4*		
Tax on Sale by DGT #2 (25%)	$	463,770	=	*$*	*1,855,080*	*x 0.25*		
Total Tax to B #2	$	1,472,578						
Net to B #2	$	8,443,522	=	*$*	*9,916,100*	*-*	*$*	*1,472,578*
Income to FAM-BIZ, INC.	$	3,091,800						
Tax at 40%	$	1,236,720						
Net to Pay Note	$	1,855,080						
Total Tax	$	2,709,298	=	*$*	*1,472,578*	*+*	*$*	*1,236,720*

After the Transaction



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