Guest Article

Warding Off Analysis Paralysis*

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We've all heard the family business statistics before, but they're worth repeating.[1] Approximately 90 percent of U.S. businesses are family firms. They range in size from small "mom-n-pop" businesses to the likes of Walmart, Ford, Mars and Marriott. There are more than 17 million family businesses in the United States, representing 64 percent of gross domestic product and employing 62 percent of the U.S. workforce. Thirty-five percent of the businesses that make up the S&P 500 are family controlled. Family businesses are also more successful than non-family businesses, with an annual return on assets that's 6.65 percent higher than the annual return on assets of non-family firms. Unfortunately, only a little more than 30 percent of family businesses survive into the second generation, even though 80 percent would like to keep the business in the family. By the third generation, only 12 percent of family businesses will be family-controlled, shrinking to 3 percent at the fourth generation and beyond.

The disconnect between what 80 percent of families intend and the far bleaker reality can primarily be attributed to a failure to plan effectively for both the family dynamics issues and the complex estate strategies necessary for successful family business succession. A companion piece to this article, titled "Succession Planning," in the March 2011 issue of Trusts & Estates[2] dealt exclusively with the role that family dynamics plays in the success or failure of family business succession planning. This article will focus exclusively on the technical estate planning issues involved in family business succession.

Take it in Phases

Estate planning for a family business owner is extremely complex. It can involve virtually all of the tools in the estate planner's toolbox, including straightforward testamentary planning, advanced gift planning, insurance issues, buy-sell agreements, and corporate recapitalizations. As estate planners, if we attempt to address all of these issues at once, we risk overwhelming the client, resulting in no estate planning getting done at all. Some call this "analysis paralysis." Our experience has shown that we can often avoid analysis paralysis by breaking down the planning into Phase I and Phase II.

Phase I planning involves those steps the business owner can take that produce a relatively large benefit to the client or his family but at a relatively low cost. In using the term "cost," we're not thinking solely of professional fees. Instead, for a business owner, the costs of implementing a planning idea can also include such things as whether the strategy involves a loss of control or access to cash flow, a significant investment of the owner's time, or even the emotional cost of addressing a particular family issue. For a business owner, essential elements of Phase I planning include testamentary transfer tax planning, planning for the management of assets left to a surviving spouse or children,

* This article was previously published in the June 2011 issue of *Trust & Estates.*
1. Family Firm Institute, Inc., Global Data Points, www.ffi.org/default.asp?id=398.
2. David Thayne Leibell, "Succession Planning," *Trusts & Estates* (March 2011) at p. 16.

asset protection planning, incapacity planning, liquidity planning, including consideration of a buy-sell agreement and life insurance.

Phase II estate planning for the business owner involves those planning ideas that may provide a significant benefit to the owner or his family but at a greater cost in terms of a greater commitment of the owner's time in implementing the plan, more complexity and professional fees, loss of control or access to cash flow, or all of the above. Examples of Phase II planning concepts include liability protection planning, advanced lifetime wealth transfer planning, and testamentary planning at a level of sophistication beyond that considered in Phase I.

Phase I

Testamentary Transfer Tax Planning

Under current law, a federal estate tax is imposed on all assets owned by an individual at death at a rate of 35 percent. Each individual is entitled to an exemption from the tax of $5 million. There's also an unlimited exemption from the tax for transfers between spouses, known as the marital deduction, provided that the recipient spouse is a U.S. citizen.[3] If an individual transfers assets to grandchildren, or to certain types of trusts for children that terminate in favor of grandchildren or more remote descendants, a separate generation-skipping transfer (GST) tax is imposed, again at a 35 percent rate and with a $5 million exemption. As of Jan. 1, 2013, unless Congress acts to change the law, the top federal estate and GST tax rate will rise to 55 percent and the exemption will decrease to $1 million.[4] In addition, some states impose an independent state-level estate tax at rates that can run as high as 16 percent or more. There are some simple steps, however, that a business owner can take to minimize these taxes at his death, including:

- **Two-share tax planning.** If the owner is married, her will or revocable trust agreement should contain planning to guarantee optimal use of both spouses' federal estate tax exemptions. Traditionally, this guarantee was accomplished by the business owner dividing her estate into two shares. The first share, sometimes called the "exemption share," would be an amount equal to the owner's federal estate tax exemption and the second share, sometimes called the "marital share," would be the balance of the owner's estate. The exemption share would pass to a trust, sometimes called a "credit shelter trust" or "bypass trust," and the marital share would pass outright to the surviving spouse or to a qualifying marital trust for his benefit. The surviving spouse could be given generous rights over the credit shelter trust, including perhaps the right to the income, principal as needed and even a limited testamentary power of appointment, but would not be given "enough" rights to be called the owner of the trust for estate-tax purposes. In this way, the trust would pass through the owner's estate with no federal estate tax (because it utilizes the owner's estate tax exemption) and through the surviving spouse's estate with no estate tax, as well (because the surviving spouse didn't own the trust for tax purposes). There would be no federal estate tax on the marital share at the owner's death because of the unlimited marital deduction. At the surviving spouse's death, the first $5 million of assets included in his estate would pass to the children, tax-free, as a result of the surviving spouse's estate tax exemption. As a result, the couple would have succeeded in sheltering two estate tax exemptions – or $10 million under current law – to the next generation rather than only one. The Tax Relief, Unemployment Insurance Reauthorization and Job Creation Act of 2010 (2010 Tax Act) provides for portability of estate tax exemptions between spouses. Thus, it shouldn't be necessary to use the two-share structure described to shelter a full $10 million of assets from tax for the children's generation. However, in our practice, we've generally recommended that clients continue to use the two-share structure rather than relying on portability for a number of reasons, including 1) The statute establishing portability is scheduled to expire at the end of 2012; 2) relying on portability fails to capture increases in the value of the exemption share between the date of the first and second spouses' deaths; 3) there's no portability of GST tax exemptions; and 4) relying on portability precludes use of the general benefits of a credit shelter trust, including creditor protection, the ability to sprinkle income among various trust beneficiaries, thereby potentially saving income tax for the family, and the ability to sprinkle principal among various trust beneficiaries, thereby possibly enabling greater tax-free gifting than would be available by relying on portability.
- **Generation skipping planning.** The two-share plan described previously can be supercharged by adding generation skipping planning. Under a generation skipping plan, the wills or revocable trust agreements of the owner and spouse would provide that the $10 million that the couple would otherwise transfer outright to the children tax-free using the two-share planning would instead be transferred to generation skipping trusts for the children. The trusts would be designed so that each

[3] If the recipient spouse is a non-U.S. citizen, the marital deduction is available only if the transfer is made to a qualified domestic trust for the benefit of the recipient spouse. Very generally speaking, a qualified domestic trust is a trust of which the recipient spouse is the only beneficiary and which has a United States resident trustee (which, in some cases, must be a United States bank). Internal Revenue Code Section 2056(d).

[4] The generation skipping transfer (GST) tax exemption is indexed for inflation, with the result that the GST exemption in effect in 2013 will be somewhat more than $1 million. See "Dynasty Trusts," Daniel L. Daniels and David T. Leibell, *Trusts & Estates* April 2007, at p. 36.

child could receive income and principal from his trust as needed, but the child wouldn't be treated as the owner of the trust for estate tax purposes. As a result, to the extent the trust assets weren't consumed by the child during the child's lifetime, they would pass to the child's children estate and GST tax-free.[4]

Spousal Marital Trusts

If the business owner doesn't want her spouse to have control over inherited assets, or if she simply wants to ensure that the spouse can't leave the inherited assets to a new spouse should he remarry after the business owner's death, the business owner can establish a marital trust to receive the spouse's share of the estate. The business owner would name some trusted individual or institution to serve as a trustee of this trust, often with the spouse as a co-trustee. The spouse would receive income for life, and principal too, if needed. Upon the surviving spouse's death, the trust terms mandate that the trust assets pass to the owner's children, thereby eliminating the ability of the spouse to give those assets to a new spouse should he remarry.

The marital trust may provide an additional benefit for certain business owner families. Consider the following two examples. In the first example, suppose the business owner holds 90 percent of the stock in "Bizco," with the remaining 10 percent owned by outside shareholders. If the owner leaves the Bizco stock outright to her husband (and the husband is a U.S. citizen), the husband will inherit it tax-free. However, when the husband later dies, he now owns a 90 percent interest in Bizco which, presumably, will be valued in the husband's estate with a control premium. In the second example, suppose instead that, during their lifetimes, the business owner and her husband were to divide the stock between them, with the owner taking 45 percent and the husband taking 45 percent. Further suppose that instead of leaving the stock outright to her husband, the owner were to leave the stock to a marital trust for his benefit. At the husband's death, instead of his estate including one 90 percent block of stock, it includes a 45 percent block owned by the estate and a second 45 percent block owned by the marital trust. If the marital trust is properly designed, case law supports the estate taking the position that the two blocks of stock should be valued separately, with the result that a minority interest discount should be available in the second example, as opposed to the control premium that applied in the first example.[5] In our practice, we find that, at least with business owners who are in long, happy marriages, this technique is a simple – and for many business owners, painless – way to reduce the value of the business owners' estates for tax purposes.

Asset Protection Trusts

Many business owners won't want to pass ownership of the business outright to a child or other descendant. Assets left outright to a child are exposed to the claims of creditors, divorcing spouses, and others who may influence the recipient to sell or otherwise use the assets in a manner inconsistent with the business owner's intentions. If the business owner instead leaves the assets to a properly designed asset protection trust, the assets can receive a significant measure of protection from the claims of the descendant's creditors or divorcing spouse. In our practice, we often find that business owners think that they already have such protection in their wills or revocable trust agreements, but are surprised to learn that if the descendant has the right to withdraw the trust funds at a particular age, the trust may not provide much protection at all.

Liquidity and Life Insurance

For a wealthy business owner, the tax planning described typically won't be sufficient to shelter the entire estate from federal and state estate taxes. Federal and state estate taxes are typically due no later than nine months after death. And an astonishing 93 percent of family business owners have little or no cash flow outside the business, according to the 2007 Laird Norton Tyee Family Business Survey.[6] Accordingly, to avoid a forced sale of the business at suboptimal prices, if there's a transfer tax exposure at the owner's death, it's critical to ensure that sufficient liquidity is available to pay the tax. This result can be accomplished through the use of buy-sell agreements in combination with life insurance planning.

1. Buy-sell agreements. A buy-sell agreement is a contractual arrangement providing for the mandatory purchase (or right of first refusal) of a shareholder's interest, either by 1) other shareholders (in a cross-purchase agreement); 2) the business itself (in a redemption agreement); or 3) some combination of the other shareholders and the business (in the case of a hybrid agreement) upon the occurrence of certain events described in the agreement (the so-called "triggering events"). The most important of the triggering events is the death of a shareholder, but others include the disability, divorce, retirement, withdrawal, or termination of employment or bankruptcy of a shareholder.

A buy-sell agreement's primary objective is to provide for the stability and continuity of the family business in a time of transition through the use of ownership transfer restrictions. Typically, such agreements prohibit the transfer to unwanted third parties by setting forth how, and to whom, shares of a family business may be transferred. The agreement also usually provides a mechanism for determining the sale price for the shares and how the purchase will be funded.

5. See, e.g., Mellinger v. Commissioner, 112 T.C. 4 (1999), action on decision, 1999-006 (Aug. 30, 1999).
6. See "Laird Norton Tyee Family Business Survey, Family to Family, 2007," http://familybusinesssurvey.com/2007/pdfs/LNT_familybusinesssurvey_2007.pdf.

Other reasons for a buy-sell agreement depend on the party to the agreement:

- **The founder –** For someone who's built the business from nothing and feels that no one can run it as well as she can, a buy-sell agreement allows the founder to maintain control while providing for a smooth transition to her chosen successors upon her death or disability. Structuring a buy-sell agreement can provide a non-threatening forum for the founder to begin thinking about which children should be managing the business in the future and which should not. Typically, a founder will want only those children who are active in the business to own a controlling interest in the stock, but will want to treat all children equally in terms of inheritance. A buy-sell agreement allows the founder to sell control to children who are active in the business and use some of the proceeds from the sale to provide for the children who aren't active in the business. By specifically carrying out the founder's intent, a properly structured buy-sell agreement avoids the inevitable disputes between the two sets of children with their competing interests.
- **The next generation –** For those children who are active in the business, a properly structured buy-sell agreement will allow them to purchase the founder's shares over time on terms that have been negotiated at arm's length, won't cripple their ability to operate the business, and may be at least partially paid by life insurance proceeds on the life of the founder. The agreement also provides a mechanism for not having to go into business with siblings (or spouses of siblings) who aren't active in the business.
- **The business –** A buy-sell agreement can help keep the business in the family and assure a smooth transition to the next generation. The agreement can also void transfers that would result in the termination of the entity's S Corporation status.
- **The founder's estate –** A buy-sell agreement can provide: 1) a market for an illiquid asset avoiding a fire sale because the sale price is determined by the agreement; 2) liquidity to pay any estate taxes; and 3) money for a surviving spouse. But under virtually no circumstances in the family business context will a "low ball" value for selling the business be respected by the Internal Revenue Service (so don't try it).[7]

2. The role of life insurance. Business owners' estates are inherently illiquid, with the business and the business real estate often representing the lion's share of the value of the estate. Family business owners are often good candidates for life insurance, which can provide instant liquidity at the business owner's death to pay estate taxes, provide for children who aren't active in the business, fund the buy-sell agreement, and provide for a spouse from a second marriage.

We typically suggest that the business owner consult with a highly qualified insurance professional in connection with liquidity planning. We find that the type of life insurance the insurance professional usually recommends in the family business succession context is permanent insurance and in particular guaranteed universal life insurance, which typically provides the largest guaranteed death benefit for the lowest cost. Although life insurance proceeds aren't income taxable to the beneficiary, such proceeds are typically taxable in the insured's estate. That's why it's so important for the insurance to be owned by an irrevocable life insurance trust (ILIT) in which the proceeds won't be subject to estate tax because they aren't considered owned by the business owner's estate. ILITs can be structured to own single life insurance policies that pay out on the death of the business owner or second-to-die life insurance policies, which pay out on the death of the survivor of the business owner and her spouse, which is typically when estate taxes are due. It's important to remember that if a business owner transfers an existing life insurance policy and dies within three years of the transfer, the proceeds are brought back into her taxable estate under IRC Section 2042. Whenever possible, structure the transaction to have the insurance trust be the initial purchaser of the policy so the insurance is out of the business owner's estate from day one.

Paying for the insurance depends on who owns the policy. If the insurance is owned by the other shareholders or the corporation in the context of a buy-sell agreement, there should be no gift consequences on paying premiums. Sometimes the insurance ownership is bifurcated between the business owner and the corporation or between the business owner and certain family trusts. This bifurcated ownership is known as split dollar, and it's crucial that the business owner work with an attorney and an insurance professional who are both highly experienced in the area of split-dollar planning, since it's filled with tax traps. If the insured is providing money to pay the premiums on the insurance owned by the irrevocable insurance trust, she can often avoid paying gift tax by qualifying the transfers as present interests gifts to the trust following the process set forth in Crummey v. Commissioner and its progeny.[8] If available annual exclusions are insufficient to pay premiums, the business owner can consider funding the insurance trust with some or all of her $5 million federal gift tax exemption. Remember, the $5 million exemption is only available, unless extended, through Dec. 31, 2012.

7. "A Practical Guide to Buy-Sell Agreements," David T. Leibell and Daniel L. Daniels, *Trusts & Estates*, March 2008 at p. 49.
8. Crummey v. Commissioner, 397 F.2d 82 (9th Cir. 1968).

Incapacity Planning

A final piece of Phase I is incapacity planning. If the owner becomes incapacitated and no planning has been done, the family may be forced to ask a court to appoint a guardian or conservator to manage the owner's financial and personal affairs. This result can be avoided in almost all cases through the simple expedient of a properly designed power of attorney and health care proxy naming the appropriate individual to make financial and health care decisions in the event of the owner's incapacity. As a power of attorney can sometimes be an unwieldy document to make decisions regarding a complex business enterprise, we often suggest that the business owner also execute a revocable living trust agreement. The owner's interest in the business can be transferred to the revocable trust during the owner's lifetime and, while the owner has capacity, she can be the trustee. Upon the owner's incapacity, a new trustee would step in to make decisions regarding the business interests held in the trust. This approach can be preferable to a power of attorney because the trust agreement can include detailed instructions for the trustee as to how to make decisions relating to the business. The trust agreement can also provide greater flexibility for appointing additional or successor trustees; this can be more difficult to do with a power of attorney.

Phase II

Liability Protection Planning

The business activities may give rise to liability risks. A well-constructed estate plan will address these risks and consider methods for insulating the owner's assets from those risks. While it's tempting for clients – and sometimes for their advisors – to think that liability protection mainly involves complex trust or corporate structures to shelter assets, we usually advise clients to first visit with their property and casualty insurance advisor to ensure that their liability insurance is adequate. A properly structured property and casualty insurance program not only can protect the business and the business owner from catastrophic losses, but also often will provide a benefit that's less discussed but perhaps equally important – the payment of legal defense costs in the event of a lawsuit against the business owner or the company. We typically advise a thorough review of the insurance programs for both the business and the business owner, including implementing a healthy amount of umbrella coverage over and above the owner's primary insurance coverage.

For further liability protection, the business owner might consider "insulation" strategies. One insulation strategy involves segregating each of the business's risky activities inside its own liability-shielding structure such as a corporation, limited liability company (LLC) or limited partnership. For example, suppose that the owner's primary business is manufacturing and that the business is operated in a building owned by the business owner individually. Each activity – the manufacturing business and the operation of the real estate in which the business is housed – should be insulated inside its own corporation or other entity. That way, in the event of a lawsuit involving the manufacturing activities, arguably only the assets of the manufacturing business itself, and not the real estate owned in the separate entity or the business owner's other assets, are exposed to the lawsuit. Although a full discussion of choice of entity is beyond the scope of this article, it often will be beneficial for the chosen entity to be a partnership or LLC, rather than a corporation, because the partnership or LLC receives pass-through status for income tax purposes.[9]

Advanced Lifetime Planning

For many advisors, wealth transfer planning is the starting point for planning for the business owner. For us, however, discussions about transferring assets to save estate taxes or to bring the junior generation into the business generally don't begin until after Phase I of the plan has been implemented. We find that this approach produces two benefits. First, it helps ensure that the business owner gets some plan in place instead of engaging in endless and sometimes confusing discussions about lifetime wealth transfer planning, all the while possibly having done nothing to ensure the orderly passage and operation of the business in the event of the owner's death or incapacity. Second, time after time, we find that the very process of going through Phase I planning can help the business owner develop a comfort level with estate planning in general that can make it easier to come to terms with the hard decisions that often need to be made about asset transfers, management succession, loss of control, or loss of access to cash flow, in implementing Phase II of the plan.

As complex as lifetime wealth transfer can be, from the standpoint of taxes alone, it's actually quite simple. If an individual attempts to transfer assets during life to avoid an estate tax, the transfer will generally instead be subject to a federal gift tax. Since the gift tax and the estate tax apply at the same rates and generally have the same exemptions, there should be no incentive for an individual to transfer wealth during life as opposed to waiting to transfer it at death. In effect, by enacting the gift tax as a companion to the estate tax, Congress created an "airtight" transfer-tax system. There are, however, leaks in that system. The three primary examples of those leaks are removing value from the system, freezing value within the system, and discounting values within the system.

Removing value from the system is hard to do. In most cases, if an individual makes a gift during lifetime, that gift is brought back into the taxable estate at death for purposes of calculating the estate tax on the individual's estate. However, there are two exceptions to this general rule, which are the annual gift tax exclusion and the "med/ed" exclusion. If an individual makes a gift using his $13,000 annual gift tax exclusion, the gifted property is entirely removed from the taxable estate. Individuals are also permitted to make gifts

9. An S Corporation generally receives pass-through status as well, but can be less beneficial than a partnership or LLC at the death of the owner. Assets held inside a partnership or LLC can receive a stepped up cost basis if a proper election under Section 754 of the IRC is made. The Section 754 election isn't available for assets held inside an S Corporation.

of unlimited amounts for tuition and certain medical expenses, as long as the payment is made directly to the provider of services. Such med/ed gifts are entirely excluded from the taxable estate.

Freezing value within the system usually connotes the individual making a gift using some or all of his lifetime exemption from federal gift tax. For example, a business owner might make a gift of $5 million worth of stock in the business to a child. Upon the owner's death, the $5 million gift is brought back into the estate for purposes of calculating the owner's estate tax. However, it's only brought back into the estate at its value at the time the gift was made and should be sheltered from tax at that time via the use of the owner's $5 million estate tax exemption.[10] Accordingly, if the value of the gifted property increases between the date of the gift and the date of the owner's death, the appreciation avoids transfer tax. That is to say, the owner succeeds in "freezing" the value of the gifted property at its date-of-gift value.

A holy grail of estate planners has been to find a way of freezing the value of an asset at some number lower than what it is actually "worth" to the owner's family, also known as discounting values. Suppose a business owner owns all of the stock in business with an enterprise value of $5 million. If the business owner gives all of the stock to her child, she will have made a taxable gift of $5 million. On the other hand, suppose that the business owner gives half the stock to one child and half to the other child. An appraiser is likely to opine that the interests received by the children are subject to lack of control discounts, since either child could deadlock the other in a vote involving the stock. If the appraiser applies, say, a 20 percent lack of control discount, the value of the gift would be reduced to $4 million. Accordingly, the business owner succeeds in freezing values at something less than the full value of the business in the eyes of the family as a whole.[11]

One of our favorite examples of a technique that can remove, freeze, and discount values all in one fell swoop is the spousal estate reduction trust (SERT). In a typical SERT, the owner creates an irrevocable trust, naming her husband or some other trusted individual or institution as trustee. During the life of the owner and her spouse, the trustee is authorized to sprinkle income and principal among a class consisting of the owner's husband and descendants. Upon the death of the husband, the remaining trust assets are divided into shares for descendants and held in further trust. The owner's gifts to the SERT can qualify for the gift tax annual exclusion because the trust would include Crummey withdrawal powers for each of the owner's descendants. This removes value from the owner's estate. If desired, the owner could use the trust as a repository for a larger gift using her lifetime gift tax exemption, thereby freezing values for transfer-tax purposes. Moreover, the asset to be gifted to the trust can be interests in the closely held business, which a qualified appraiser may value by applying discounts for lack of control and lack of marketability, thereby achieving a discounting of asset values for transfer tax purposes.

Beyond being a good vehicle through which to achieve the wealth transfer trifecta of removing, freezing, and discounting values, the SERT provides a number of other benefits. The trust includes the grantor's spouse as a beneficiary. To avoid an argument that the trust should be included in the grantor's estate under Internal Revenue Code Section 2036, the grantor mustn't have any legal right to the assets held in the SERT, nor can there be any prearrangement or understanding between the grantor and her spouse that the grantor might use assets in the trust. Nonetheless, if the grantor is in a happy marriage, it can be comforting to know that her spouse will have access to the property in the trust even after the gift. As an additional benefit, the SERT would be established as a grantor trust for income tax purposes. As a result, the business owner would pay income tax on the income and gains earned by the trust. This depletes the owner's estate and enhances the value of the trust, but isn't treated as a taxable gift, in effect providing a very powerful additional means of removing value from the transfer tax system. Finally, the business owner could allocate her GST tax exemption to the SERT, thereby removing the gifted assets from the transfer tax system for multiple generations.

Additional popular wealth transfer strategies for business interests include the grantor retained annuity trust (GRAT) and the sale to an intentionally defective irrevocable trust (IDIT). The basic concept behind a GRAT is to allow the business owner to give stock in the business to a trust and retain a set annual payment (an annuity) from that property for a set period of years. At the end of that period of years, ownership of the property passes to the business owner's children or to trusts for their benefit. The value of owner's taxable gift is the value of the property contributed to the trust, less the value of her right to receive the annuity for the set period of years, which is valued using interest rate assumptions provided by the IRS each month pursuant to IRC Section 7520. If the GRAT is structured properly, the value of the business owner's retained annuity interest will be equal or nearly equal to the value of the property contributed to the trust, with the result that her taxable gift to the trust is zero or near zero. How does this benefit the business owner's children? If the stock contributed to the GRAT appreciates and/or produces income at exactly the same rate as that assumed by the IRS in valuing the owner's retained annuity payment, the children don't benefit because the property contributed to the trust will be just sufficient to pay the owner her annuity for the set period of years. However, if the stock contributed to the trust appreciates and/or produces income at a greater rate than that assumed by the IRS, there will be property "left over" in the trust at the end of the set period of years, and the children will receive that property – yet the business owner would have paid no gift tax

10. In the view of some commentators, if the decedent makes a gift in a year when the gift tax exemption is $5 million but dies in a year in which the exemption is some lower amount, the estate will be taxed on the difference between the two exemptions. This is sometimes referred to as a "claw back" of the tax that "should have been" paid on the gifted asset. For a good discussion of this complex issue, see Evans, "Complications from Changes in the Exclusion," LISI Estate Planning Newsletter #1768 (Jan. 31, 2011) at www.leimbergservices.com.

11. In Revenue Ruling 93-12, 1993-7 I.R.B. 13 (Feb. 16, 1993), revoking Rev. Rul. 81-253, 1981-1 C.B. 187. the IRS ruled that gifts of separate minority interests in stock wouldn't be aggregated for purposes of determining whether a lack of control discount should be applied.

on it. The GRAT is particularly popular for gifts of hard-to-value assets like closely held business interests because the risk of an additional taxable gift upon an audit of the gift can be minimized. If the value of the transferred stock is increased on audit, the GRAT can be drafted to provide that the size of the business owner's retained annuity payment is correspondingly increased, with the result that the taxable gift always stays near zero.

When we suggest a GRAT to a business owner, we nearly always invite her to compare the GRAT with its somewhat riskier cousin, the IDIT sale. The general IDIT sale concept is fairly simple. The business owner makes a gift to an irrevocable trust of, say, $100,000. Some time later, the business owner sells, say, $1 million worth of stock to the trust in return for the trust's promissory note. The note provides for interest only to be paid for a period of, say, 9 years. At the end of the 9th year, a balloon payment of principal is due. The interest rate on the note is set at the lowest rate permitted by the IRS regulations. There's no gift because the transaction is a sale of assets for Fair Market Value. There's no capital gains tax, either, because the sale is between a grantor and her own grantor trust, which is an ignored transaction under Revenue Ruling 85-13.

How does this benefit the business owner's children? If the property sold to the trust appreciates and/or produces income at exactly the same rate as the interest rate on the note, the children don't benefit, because the property contributed to the trust will be just sufficient to service the interest and principal payments on the note. However, if the property contributed to the trust appreciates and/or produces income at a greater rate than the interest rate on the note, there will be property left over in the trust at the end of the note, and the children will receive that property, gift tax-free. Economically, the GRAT and IDIT sale are very similar techniques. In both instances, the owner transfers assets to a trust in return for a stream of payments, hoping that the income and/or appreciation on the transferred property will outpace the rate of return needed to service the payments returned to the owner. Why, then, do some clients choose GRATs and others choose IDIT sales?

The GRAT is generally regarded as a more conservative technique than the IDIT sale. It doesn't present a risk of a taxable gift in the event the property is revalued on audit. In addition, it's a technique that's specifically sanctioned by IRC Section 2702. The IDIT sale, on the other hand, has no specific statute warranting the safety of the technique. The IDIT sale presents a risk of a taxable gift if the property is revalued on audit and there's even a small chance the IRS could successfully apply Section 2702 to assert that the taxable gift is the entire value of the property sold rather than merely the difference between the reported value and the audited value of the transferred stock. Moreover, if the trust to which assets are sold in the IDIT sale doesn't have sufficient assets of its own, the IRS could argue that the trust assets should be brought back into the grantor's estate at death under IRC Section 2036. Also, with a GRAT, if the transferred assets don't perform well, the GRAT simply returns all of its assets to the grantor and nothing has been lost other than the professional fees expended on the transaction. With the IDIT sale, on the other hand, if the transferred assets decline in value, the trust will need to use some of its other assets to repay the note, thereby returning assets to the grantor that she had previously gifted to the trust – a waste of gift tax exemption.

Although the IDIT sale is generally regarded as posing more valuation and tax risk than the GRAT, the GRAT presents more risk in at least one area, in that the grantor must survive the term of the GRAT for the GRAT to be successful; this isn't true of the IDIT sale. In addition, the IDIT sale is a far better technique for clients interested in generation skipping planning. The IDIT trust can be established as a dynasty trust that escapes estate and gift tax forever. Although somewhat of an oversimplification, the GRAT generally isn't a good vehicle through which to do generation skipping planning.[12]

As important as it may be for the business owner to understand the risks and benefits of a GRAT versus an IDIT sale, in our practice we've found that the primary driver of which technique to choose is cash flow. With an IDIT sale, the note can be structured such that the business owner receives only interest for a period of years, with a balloon payment of principal and no penalty for prepayment. This structure provides maximum flexibility for the business to make minimal distributions to the IDIT to satisfy note repayments when the business is having a difficult year and for the business to make larger distributions in better years. With the GRAT, on the other hand, the annuity payments to the owner must be structured so that the owner's principal is returned over the term of the GRAT, and only minimal backloading of payments is permitted. Accordingly, the GRAT tends to be the technique of choice where the business produces fairly predictable cash flow while the IDIT sale is chosen more often when cash flow is more erratic.

Additional Advanced Strategies

In addition to the estate planning strategies for family business owners that have already been discussed, there are a number of other estate planning strategies for family business owners that can be extremely effective in the right circumstance but are beyond the scope of a general overview. These include preferred partnership freezes (private annuities and self-cancelling installment notes (SCINs). The unique nature of particular industries, such as commercial real estate, can also require highly tailored estate planning strategies. While many of these advanced strategies require separate articles of their own, we can address a few here, including charitable planning strategies, the special issues presented by holding closely held business interests in trust, and postmortem planning.

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12. It's not possible to allocate GST exemption to a grantor retained annuity trust (GRAT) until the close of the estate tax inclusion period, which is the end of the GRAT term. By that time, most of the anticipated appreciation in value may have occurred, thereby preventing the leveraging of the owner's generation skipping exemption. IRC Section 2642(f)(1).

1. Charitable planning. Although lifetime charitable strategies, other than the charitable stock bailout, in which a charitable remainder trust is used to redeem the senior generations' shares in a tax-efficient manner, are typically not common in family business succession planning, testamentary charitable planning strategies can be among the most effective estate planning strategies for business owners who have done little or no lifetime planning.

Using what's known as the testamentary note-CLAT, this kind of planning can not only, under the right circumstances, keep the next generation of family members in control of the business, but also minimize or eliminate estate taxes and provide some amount for charity, even for a private foundation controlled by the business owner's family.[13]

A second highly effective testamentary strategy is known as a charitable lid. Although it can be structured in a variety of ways, basically a charitable lid is a planning technique that guarantees that if the IRS questions a valuation discount on an estate or gift tax audit and succeeds, the difference won't go to the IRS in the form of estate or gift tax, but rather to one or more charities named in the estate plan. This type of planning is thought to discourage the IRS from questioning valuation discounts, because even if the IRS succeeds, it won't collect any additional amounts since such amounts will pass to charity.[14]

2. Holding closely held business interests in trust. Under the Uniform Prudent Investor Act, which has been adopted in most jurisdictions, trustees are required to diversify trust assets unless special circumstances or a specific direction justify not diversifying. Diversifying many times defeats the purpose behind most trusts holding family business interests – which is to preserve the business in the family. How do we protect trustees of trusts that hold concentrated positions in family businesses from surcharge liability for failure to diversify?

One way is to indemnify the trustee for failure to diversify out of the family business interests by specifically referencing the business in the trust instrument and instructing the trustee to continue to hold the stock unless certain specified events occur. These events could include continued poor performance of the business over a period of years or the consent of all or a supermajority of the beneficiaries.

If the trustee is still concerned, even with the protective language, it would be prudent to establish the trust as a directed trust in a state like Delaware. Under a directed trust, the trustee would serve primarily as an administrative trustee and a committee not involving the trustee (but likely including family members) handles investment issues regarding the family business.

3. Post-mortem planning. Sometimes, the family business owner never gets around to doing effective liquidity planning. If that's the case, the tax code provides assistance by offering the ability under certain circumstances for the estate tax to be paid over a period of years to avoid a fire sale of the business to pay estate taxes. IRC Section 6161 allows a one-year hardship extension (renewable with IRS approval) for reasonable cause in the discretion of the IRS. IRC Section 6166 allows a 14-year extension if the business interest exceeds 35 percent of the decedent's adjusted gross estate. The first five years are interest only. Rigid rules accelerate the tax if there's a disposition of more than 50 percent of the value of the stock. An additional means of financing estate taxes is known as a "Graegin loan" in which the business owner's estate borrows funds needed to pay estate taxes on the business from a commercial lender – or, in an aggressive form of the technique, from a related entity – and deducts all of the interest on the loan in a lump sum on the estate's tax return.[15]

Executing the Plan

Estate and succession planning for family business owners can be very frustrating for both the business owner and her advisors. It's very complicated from both a family dynamics and estate-planning viewpoint. Unfortunately, it's made many times more difficult by the lack of collaboration among the advisors working on the estate and succession plan. It's not unusual for there to be a long-term entrenched advisor who's in over his head and threatened by the involvement of outside experts. This entrenched advisor can sometimes be more of an obstacle than a facilitator of the estate and succession plan, with drastic results for both the family business and the family itself. As Rousseau posited centuries ago, and John Nash, of A Beautiful Mind, proved mathematically, collaboration lifts all boats, including hopefully, that of the entrenched advisor.

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13. David T. Leibell and Daniel L. Daniels, "Never Can Say Goodbye," *Trusts & Estates* (October 2005) at p. 54.
14. Daniel L. Daniels and David T. Leibell, "Christiansen Is a Boon for Charities," *Trusts & Estates* (December 2009) at p. 14; "Charitable Lids Triumph Again," David Thayne Leibell, *Trusts & Estates*, Wealth Watch, http://trustsandestates. com/wealth_watch/charitable-lids-win-in-petter0120/.
15. See Daniel L. Daniels and David T. Leibell, "Post-Mortem Planning for the Closely Held Business Owner," ALI-ABA Audio Seminar, Oct. 29, 2008, www.ali-aba.org.