SUCCESSION, TAX AND ESTATE PLANNING ISSUES IN TRANSFERRING A FAMILY-OWNED BUSINESS

By

David M. Naples, Esq.
Lowell V. Stortz, Esq.
Leonard, Street and Deinard

I. OVERVIEW AND INITIAL CONSIDERATIONS.

A. APPROACHES TO SUCCESSION PLANNING.

1. What Is A Business Succession Plan? A business succession plan provides for the transfer of management, control, and ownership of a business to another. The success of the plan is not measured only by the health of the business, but also by the health of the family.

2. Why Have a Succession Plan?

(a) Maximize Wealth. Maximize the amount of wealth transferred to heirs by (i) developing a plan to enhance the heirs' successful operation of the business, and (ii) minimizing taxes.

(b) Provide for Surviving Spouse and Minor Children. In addition to passing wealth to heirs, a succession plan ensures sufficient income for the surviving spouse and minor children.

(c) Provide Retirement Income. Provide retirement income for the owners after a sale or transfer of the business.

(d) Treat Children Fairly. The owner can plan what children are best suited to operate the business and empower them to do so appropriately. At the same time, they can also plan on what to leave to the children who are not active in the business.

(e) Control. The owner can determine who will control and manage the business.

(f) Key Employees. The owner can determine how to retain and provide incentives to key nonfamily employees.

(g) Promote Family Harmony. With proper planning, the owner can reduce dissention and conflict among family members.

3. Statistics.

(a) Prevalence of Family Businesses. An estimated 80% of all U.S. businesses are family owned or managed.[1] These businesses account for up to 50% of both the employment in the U.S. and of the GNP.[2]

(b) Probability of Business Failure. Planners and client should remain cognizant that (i) only 30% of family owned businesses survive past the first generation business owner and (ii) only 15% survive past the second generation.[3]

(c) Causes of Business Failure. The complexity and differences among families and their businesses make it difficult to discern precisely which factors cause the high rate of succession failures. However, recent studies have identified the following factors common to typical succession failures:[4]

(i) The interaction (e.g. conflict, distrust) among successor family members accounts for approximately 60% of typical succession failures;

(ii) Heirs who are not prepared to manage the business represent approximately 25% of typical succession failures; and

(iii) Surprisingly, *ONLY 10%* of typical succession failures result from transfer taxes. However, estate planning that minimizes the impact of these taxes certainly contributes to this low percentage.

(d) What to Take From Statistics.

(i) Understand What Statistics Tell Us. Most succession plans were designed to address only the traditional assumptions that family business succession failures result primarily from transfer taxes and poor management decisions. These succession plans focused on tax sensitive legal documents to reduce income and transfer taxes and used other quality legal tools designed to effectively delegate and transfer authority. Those plans are good to the extent they controlled the impact of taxes and properly focused decision-making authority on the right person(s), but that approach ignores the statistics which reveal: (A) that conflict between heirs is 6 times more likely to lead to the business' failure than transfer taxes,

---

1 R. Duman, "Family Firms Are Different," *Entrepreneurship Theory and Practice*, 1992, pp.13-21; and M. F. R. Kets de Vries, "The Dynamics of Family Controlled Firms: The Good News and the Bad News," *Organizational Dynamics*, 1993, pp. 59-71.

2 W. G. Dyer, *Cultural Change in Family Firms*, Jossey-Bass, San Francisco, 1986; and P. L. Rosenblatt, M. R. Anderson and P. Johnson, *The Family in Business*, Jossey-Bass, San Francisco, 1985.

3 Arthur Anderson/Mass Mutual, American Family Business Survey, 1997.

4 M. H. Morris, R. W. Williams and R. A. Avila, "Correlates of Success in Family Business Transitions," *Journal of Business Venturing*, 1997, p. 7.

and (B) unprepared heirs are 2-1/2 times more likely to cause the business' failure than transfer taxes.

(ii) Consider Relationships and Preparation. The business succession plan must address the interaction between heirs and their preparation to successfully operate the business. The planner must advise clients of the destructive nature of family conflict and identify professional advisors who can properly address conflict issues.

(iii) Consider Sale of Business. The sale of the business, either during the owner's life or at death via a buy/sell agreement, should be viewed as a succession planning tool. Generally, a business has more value during the owner's life. A proper disposition plan avoids a "fire" sale after death. By avoiding such a sale, the owner will/can maximize the wealth transferred to the next generation.

4. Causes of Family Conflict Between Heirs. Conflict may arise over many subjects such as the selection of successors, compensation, dividend policies, and family rivalries. However, the actual origin of the conflict may stem from many causes including:

(a) Family Relationships. The uniqueness and complexity of relationships between siblings, spouses (both the owner's and children's) and generations alone can cause severe conflict. Emotions and loyalty can have a powerful impact on familial relations. Family members often bring personal problems to work, which can have a severely distracting impact on the business.

(b) Decision Making Process. Family members usually find it difficult to evaluate business decisions separate and apart from the family. Rather, they have the tendency to evaluate business decisions based upon the impact on both the business and the family. For example, a business decisions may be: (i) good for the business and good for family; (ii) bad for business and bad for family; (iii) good for business and bad for the family; or (iv) bad for business and good for family. [5]

(c) Number of Family Members. The amount of disagreement and dissention increases as the number of family members involved in the decision-making process increases. More people are evaluating whether a decision is good for the business and or the family (or themselves).

(d) Balancing of Family and Business Systems. A family business involves both a family system and a business system. Most individuals do not need to, and therefore, have not learned how to balance the convergence of the family and business systems. These systems are guided by different principals. In family businesses, an event in one system affects the other. Circular conflicts exist. That is, a conflict in the family impacts the business decision which in turn can impact the family. Understanding the guiding principals of each

---

[5] See Friedman, *A New, More Effective Planning Strategy for Family Businesses*, Estate Planning, June 1999, Vol 26, No 5.

system is critical to development of an effective succession plan. The principals of these systems are summarized as follows:

Family System	Business System
Tied to Emotions	Objective & Rational
Unconditional Acceptance	Performance Evaluations
Forgiving	Mistakes Considered
Broad Experiences Encouraged	Business Focus
Equality Based	Competence Based
Lifetime Relationships	Time Relationships
Authority Birth Order	Power and Role Authority

(e) Lack of Trust. Distrust constitutes the root of much family conflict. Lack of trust can arise for many reasons but for succession planning owners and advisors should carefully consider the following factors:

(i) Poor Communication. Often, family members poorly communicate business decisions to each other. As a consequence/consequently, family members may misunderstand these decisions and may lead to family members feeling isolated and unsure about the business or their role in it. Many people fear and/or distrust what they do not understand.

(ii) Poor Performance. Many families use the business as a resource for the entire family and employ unqualified family members or retain poorly performing members. Family members often distrust a business manager who operates the business in such a manner.

(iii) Inconsistent Actions. Mistrust may result if successors act inconsistently. Shifts in position are likely to occur when the successor is not provided guidance on the business/family objectives or is unprepared to serve as successor.

5. Elements of a Succession Plan. The following elements should be considered when developing a succession plan:

(a) Seek and Prioritize Objectives. Don't let the tax laws control the succession planning. Wealth preservation and tax reduction is not always the "primary objective" of each estate or succession plan. The owner should first establish his or her priorities and then consider tax efficient planning methods to achieve those objectives. For example, consider whether the owner's priority is welfare of a spouse over survival of the business, survival of the business over equality among children, or simply retirement income.

(b) Plan For Relationships - Enhancing Trust. Owners must be made aware about the destructive nature of conflict among heirs and should consider options to reduce conflict and foster trust. Consider incorporating the following ideas into the plan:

(i) Emphasize Business Results.

(A) No Handouts. Merit should determine control and employment. Likewise, performance should determine job retention. Trust and dissention may increase if those producing poor results are permitted to maintain their positions or granted greater responsibility.

(B) Non-Family Directors. Consider appointing disinterested non-family directors. They can provide objective and unbiased feedback on performance and results.

(ii) Family Mission Statement. The family should create a mission statement to guide future successors.

(A) Benefits and Content. Trust in the successor may increase if the successor acts consistently, whereas, mistrust often results when successors act inconsistently. The mission statement will provide the successor a much needed road map and allow family members a means by which to evaluate the successor. Furthermore, the process of creating the mission statement may itself, foster family cohesiveness. The mission statement should address such items as:

(1) Purpose of Business. Explain what the business does and future expansions.

(2) Who May Participate. State who may participate and what qualifications and preparations are required.

(3) Performance Standards. Specific standards such as education, experience, salary, job descriptions and performance should be formulated for all family members participating in the business. The standards should address the means by which job performance is evaluated and the consequence of poor performance thereunder.

(4) Titles. Describe how and who determines the employee titles and the authority and responsibility attached to each.

(5) Expectations of Family. Set forth the expectations of both family members participating in the business and those not participating in the business.

(6) Conflict Resolution. Explain how the family should resolve conflicts between itself and the business. Simply directing the parties to mediation or arbitration may not suffice. For example, trust may be more enhanced if the parties first attempt to resolve the conflict among themselves, turn to a family counsel and then the board of directors before employing more formal dispute resolution methods.

(B) Implement the Mission Statement. Legal documents implement the mission statement. For example, if the family wants to remain active in the community, organizational documents may permit contributions to particular charities and/or leave sponsoring certain events.

(iii) Family Counsel. Consider establishing a family counsel, to whom the family business and family members can seek for guidance on: (A) family values, (B) direction for the family business, and (C) resolution of family conflicts. A family counsel may help foster communication thereby, reducing misunderstanding, misconception, and distrust.

(iv) Encourage Business Meetings. Confidence and trust is enhanced by allowing people to participate in the decision-making process. The use of "unanimous consents" prevents a meaningful opportunity to enhance family trust through full discussion. Consider limiting the use of "unanimous consents" to time sensitive matters and encourage meetings of directors and shareholders.

(c) Determine Who Gets Control and Ownership. As discussed more fully below, control and ownership constitute two distinct rights. Furthermore, control differs from the day-to-day management authority.

(i) Control.

(A) Who Gets Control. Generally, as few people as possible should have the ability to exercise control. The breeding ground for dissention increases with the number of people in control. To reduce dissention and conflict among heirs, competence and merit should determine the successor.

(B) When is Control Transferred. Equally important as to who gets control is the time at which the control is transferred. To allow for an orderly transition, avoid transferring control after the owners dies or becomes disabled. In addition, tensions could result between the owner and the successor if the owner transfers control too soon. It may be best for an owner to identify but not announce the successor and then gradually withdraw. This will permit the owner the opportunity to train and gain confidence in the successor and step in only when needed.

(ii) Ownership.

(A) Too Many Owners. Generally, the fewer owners, the better. All owners must have a clear understanding of the standards for ownership and control. A clear family mission statement should accomplish this objective. Nevertheless, as with control, decision-making can cause conflict with too many owners. Loyalty to a business also tends to decline with the dilution of ownership. Several owners make it difficult to divide profits between (1) active, productive owners, (2) active, non-productive owners, and (3) non-active owners.

(B) Use Other Assets to Create Equality. When possible, transfer ownership of the family business to those active in the business and transfer other assets to non-active business owners. Insurance may be a nice substitute in this regard. If sufficient nonbusiness assets do not exist, consider giving voting interests to active family members and nonvoting interests to inactive family members.

(C) Buyouts. Reduce the number of owners by using shareholder agreements to allow active owners to acquire the interests of non-active owners and to allow inactive family members to transfer interests to active owners. The ability of a business to satisfy the buyout without harm to the business must also be considered. To provide inactive owners an incentive to sell, the shareholder agreement may:

(1) provide for traditional security;

(2) include limitations on the company to preserve its ability to satisfy a buyout;

(3) allow selling family members to participate in a "premium price" if the business is sold shortly after the buyout; and

(4) include a realistic and affordable valuation mechanism.

(D) Lifetime Transfers. Consider using lifetime transfers to reduce estate taxes and avoid possible fire sales after the owner's death. Generally, such transfer can be structured in a tax efficient manner while allowing the owner to maintain control. Exercise caution if the business constitutes the owner’s main source of cash flow because distributions from most entities must be pro rata. In this event, an employment agreement may secure income to the owner. Lifetime transfers provide many benefits including:

(1) fragmenting interests to generate or enhance gift and estate tax valuation discounts;

(2) diminishing liquidity problems by reducing the size of the owner's gross estate; and

(3) transfer future appreciation.

(4) in some instances, a retained income flow

(E) How to Transfer Ownership. The owner must decide if he wants to give the business away, sell it, or do some of each. He must further consider whether the transferee should be an individual, trust or some other entity.

(F) Inform Children About Fairness and Equality. Make sure children and other family members understand the difference between fairness and equality.

(G) Key Employees. Generally, avoid giving key employees ownership, if possible. If they desire an equity interest, consider compensation plans that simulate ownership such as phantom stock plans.

(H) Non-Family Owners. Non-family owners in general provide complexities for estate planning purposes because: (1) interests may not be freely transferred; (2) valuation strategies may not be fairly implemented; and (3) fiduciary duties of directors and officers may be increased.

(d) Don't Forget About Retirement. Often, the family business comprises a substantial portion of the owner's wealth and cash flow. As such, owners have a difficult time transferring the business during their lifetime. Such owners have a tendency to over-scrutinize the actions of the younger generation and inject themselves back into the business. Cash flow planning for the owner, *and his or her spouse*, should be a primary consideration in all cases. For example, will retirement income come from (i) dividends; (ii) qualified pension plans; (iii) nonqualified plans; (iv) non-qualified deferred compensation arrangements; (v) sale of the business to family or nonfamily; or (vi) other assets of the owner.

(e) Avoid Global Succession Plans. Large scale estate and business succession plans can be overwhelming for owners. They can also foster mistrust of family members who are asked to accept significant changes in the operation of the family business without having a voice in the process. Implementing a succession plan in stages can increase family participation and the opportunity to monitor the plan.

(f) Liquidity Planning. The succession plan must consider whether sufficient funds exist to pay estate taxes. This commonly involves (i) use of the marital and/or charitable deductions to defer estate tax until the second spouse's death or avoid estate tax on charitable transfers, and (ii) life insurance.

(g) Taxes. Through proper and timely planning, business owners can achieve significant estate tax savings. Gifting strategies are central to these savings because they remove appreciation from the owner's gross estate. Valuation discounts provide an opportunity to leverage the economic interest transferred. The planner should consider the benefits of IRC §§2055, 2056, 2057, 2032A, 303 and 6166.

(h) Assemble the Team. It is not uncommon for a single advisor to prepare the succession plan. This plan may be inadequate because it may narrowly focus on the advisor's strengths and comforts. A well rounded team will include tax counsel, estate tax counsel, business counsel, the owner's accountant, a family/business advisor, and an insurance advisor or financial planner.

(i) Estate Planning Documents. Coordinate estate planning documents with the succession plan. In this regard consider the following:

(i) Allocation of Business Interests. Make sure the dispositive estate planning document provides flexibility for allocating business interests to either the unified credit share or marital deduction share.

(ii) Specific Bequests. Consider using specific bequests of business interests to certain family members.

(iii) Timing. If the owner wants to transfer the business to only certain family members after his or her death, determine whether such transfer will occur at the first spouse's death or at second spouse's death. Plan how to pay estate taxes if the transfer occurs at the first spouse's death. If the transfer occurs at the second spouse's death, consider using a separate QTIP trust to hold the transferred business.

(iv) Death Taxes. Consider estate tax apportionment carefully, particularly if assets are not divided pro rata among beneficiaries.

(v) Fiduciaries. Who will serve as personal representative and trustee is a vital decision because they may ultimately hold the business interest. The fiduciary must also be granted sufficient authority to operate and continue the business.

(vi) S Corporations. Recall special requirements for trust ownership.

(j) Disability. The succession plan should consider the potential disability of the owner. To provide for continuity during disability consider:

(i) Powers of Attorney. Using general powers of attorney to give the agent sufficient authority to allow continuation of the business.

(ii) Revocable Trust. A revocable trust may be a better option if disability concerns are substantial.

(iii) Cash Flow. Determine if the owner has sufficient disability insurance. To facilitate the deductibility of disability payments from the business to the disabled donor, consider having a formal disability plan.

(k) Overcome Reluctance to Plan. No succession plan can be effective if it not developed or implemented. Most business owners procrastinate about succession planning for various reasons, including:

(i) Strong Willed. Because business owners are strong willed with strong personalities, they enjoy control. As such, they perceive succession planning as a threat to control.

(ii) Lifeline. Business owners are often married to the business. They rarely have time for outside interests and worry about boredom.

(iii) Primary Financial Asset. A family business often provides the majority of a client's (or family's) wealth. Therefore, owners often depend on the business to fund their lifestyle. As a result, owners are reluctant to part with their "money tree."

(iv) Failure to Appreciate Risks. Most owners, and planners, fail to appreciate problems associated with personal relationships of the heirs.

B. DETERMINING OWNER’S NEEDS.

1. General. Each owner’s needs are unique. An owner and his or her planner must assess the owner’s needs based on the owner’s objectives. This requires a thorough inquiry into the owner's business, overall wealth and family. Only then may a plan be created that emphasizes the owner’s unique needs. The owner and the planner must identify potential impediments to the preservation of the business and the family, such as: (a) qualifications of children to manage business, (b) more than one child managing business, (c) inactive family members as owners, and (d) timing of the transfer.

2. Should the Family Business be Preserved in the Family? The owner must first assess whether the business should be preserved or sold. The question often turns on which option produces the best opportunity to pass wealth to the next generation, provides for a surviving spouse and minor children, and also maintains family harmony. Key items to consider include:

(a) Can the founder be replaced?

(b) Are there any members of the founder's family interested and *"capable"* of managing the business?

(c) Is there a means of providing sufficient cash flow to the founder during his/her retirement and to his/her spouse after his/her death without liquidating the family business?

(d) What is the impact of estate or income taxes?

3. Common Objectives of Owner. Common objectives of many owners include:

(a) Control. Maintain control of business until retirement or death of shareholder.

(b) Cash Flow. Maintain standard of living for the owner and spouse during his/her retirement and for the spouse after the founder's death.

(c) Fairness to Children. Distribute estate fairly among all children. This requires the planner to ascertain (i) the owner's concept of fairness and equality, (ii) the value of the business attributed to a child active in the business, and (iii) when equality is to be determined, death or disability?

(d) Allocation of Business. Allocate ownership of the business to those children active in the management of the business.

(e) Minimize Taxes. Consistent with the above objectives, minimize death taxes and other transfer costs.

4. Fact Gathering. Some basic information the planner needs to assist an owner to create a succession plan includes the following:

- Owner’s objectives
- Family history
- Business *and personal* financial statements
- Business *and personal* cash flow statements
- Evaluate the cash reserves and how they are managed.
- Need for interim guidance by experienced personnel until the owner’s children mature in age and experience.
- Directors, officers and key employees including both family members and non-family members.
- Owner’s key advisors to the company.
- Has anyone been promised ownership or control of the company?
- Which family members, if any, want ownership/control?
- Any non-family employees want ownership/control?
- Critical third parties, i.e., customers/clients, lenders, material supplies and creditors.
- Current salaries, bonus/incentive plans, and retirement plans.
- How are non-family key employees are compensated?

- The structure under which the business operates, i.e., Corporate, partnership, FLP, LLC, sole-proprietorship, or trust.
- Any loyalties that exist between different directors, officers, and key employees.
- Is there a business plan? Short term? Long term?
- How does the owner make and implement major business decisions?
- Is there a functioning Board of Directors?
- What makes the business profitable? What is unique about its operations, product or service? What is the good will of the business?
- Primary competitors of the business?
- Which market forces can disrupt or threaten the business?
- Special education, training or experience needed to run the business.
- Can there be a gradual transfer of both control and ownership?
- Can there be short-term and long-term transitions?
- Level of commitment to the future of the family business.
- Level of devotion by family members to the business.
- Level of trust among family members.

C. CONTROL AND OWNERSHIP ISSUES IN SUCCESSION.

1. Different Rights. Remember, control and ownership are synonymous. Ownership relates to an equity interest in the business which may be voting or non-voting. Control usually relates to an owner's ability to make major decisions by virtue of equity voting rights. For example, in limited partnerships, the general partner typically has a very small ownership interest in the partnership yet has voting control of the partnership.

2. Voting/Non-Voting Stock. Use of voting and nonvoting stock allows many planning opportunities. The ownership structure of a corporation can be comprised of as little as 1% voting interests and 99% nonvoting interests.

(a) Owner Maintains Control. An owner can maintain control of the business by holding the voting stock.

(b) Facilitates Gifts. Lifetime gifts of nonvoting stock allow the owner to maintain control while still transferring a substantial portion of the business value to heirs.

(c) Discounts. The planner can also discount the value of nonvoting stock for transfer tax purposes based on a lack of marketability or lack of control. Furthermore, a discount may reduce the impact of control premium attached to voting stock.

(d) Disposition of Control. Control of the business may be more easily allocated to active family members because there are less voting interests. A voting trust can also insure management control of the company.

(e) S-Corporations. S-Corporation are permitted to have both voting and nonvoting stock.

(f) 2036(b) and 2701. No problems are encountered by IRC §§ 2036(b) or 2701.

(g) Effect on Distributions. The planner must remain cognizant that corporate distributions must be pro rata.

3. Preferred Stock. This may be given to inactive family members because it gives them a preferred rate of return. Furthermore, an owner may retain voting preferred stock and transfer common stock to active family members (e.g. estate freeze). The company should have sufficient cash flow to pay the dividend.

(a) Benefits. Future appreciation is designed to benefit the common stock holders who are usually the active family members.

(b) Drawbacks. Dividends are taxable income to the preferred stock holder and nondeductible to the corporation. S-Corporations usually cannot have preferred stock because it may not have a second class of stock. The planners should exercise caution such that estate freezes do not run afoul of IRC § 2701.

4. Other Entities. Other entities, such as limited partnerships and limited liability companies may also utilize voting and nonvoting interests to allow the owner to maintain control.

II. TOOLS OF SUCCESSION PLANNING.

A. LIFE INSURANCE.

1. Overview. Liquidity is an essential component to carryout any business succession plan and life insurance is one of the most cost effective means to create liquidity. It is needed to (a) fund the owner's retirement or disability, (b) fund buy outs, (c) fund nonqualified deferred compensation arrangements, (d) pay estate taxes , (e) provide working capital to the

business upon the death of a key person, and (f) provide for a surviving spouse or minor children.

2 Uses of Life Insurance.

(a) Assets to Inactive Members. Life insurance is an excellent means to create assets for family members not active in the family business to provide equality.

(b) Pay Estate Taxes. Life insurance can be one of the most economically efficient means to pay estate taxes.

(i) Irrevocable Life Insurance Trust. To avoid inclusion of the life insurance proceeds in the gross estate of the business owner (or the spouse), it is best to have an irrevocable life insurance trust ("ILIT") both acquire and own the policy. The ILIT can then purchase assets, including business interests, from the decedent's gross estate. The estate then will have the necessary cash to pay estate taxes, and the assets remain available for the owner's family.

(ii) Second to Die Policy. Through the proper use of the marital deduction and the applicable credit amount, all estate tax may be deferred until the second spouse's death. A cost efficient policy designed to pay taxes on a second spouse's death is a second to die policy. This policy insures both the lives of both spouses and pay out at the death of the last spouse. Of course, estate tax may be incurred upon the owner's death if the business is transferred to someone other than the surviving spouse. In this instance, a single life policy would be appropriate.

(c) Key Man Insurance. A common use for life insurance, and one of the most important uses, is to provide an influx of cash to a business to help it survive the transition period following the death of a key employee, often the owner. The potential harm to the business should be the primary criteria to determine the amount of insurance not the equity interest owned by the key person.

(d) Funding Buy-Sell Agreement. The effectiveness of a buy-sell agreement is directly tied to the purchaser's ability to pay. A promise to buy means little if the buyer has no money. Life insurance is a cost efficient means to provide the purchaser needed cash to satisfy its obligations under a buy-sell agreement. It can be used to fund a child's obligation to acquire a parent's business interest under a cross purchase buy-sell agreement. It may be important to convert the business to cash when the business is an owner's main source of wealth and income. Caution must be exercised to avoid inclusion of the life insurance proceeds in the gross estate of the owner by virtue of the owner's or business' ownership of the policy.

(e) Disability. A business may suffer the same losses upon disability of a key employee as it does upon death of a key employee. For this reason, the obligation to buy and sell under many buy-sell agreements are triggered by disability. To provide for the owner and his family, it is important that the purchaser have sufficient funds to satisfy the buy-out. The cash value of a life insurance policy is generally insufficient. Disability buy-out

("DBO") insurance can provide assistance to supplement the shortage or be the sole funding. DBO insurance is not a substitute for disability income insurance which replaces the compensation of the disabled person.

(f) Nonqualified Deferred Compensation. A nonqualified deferred compensation ("NQDC") plan is an employer's unsecured promise to pay compensation to an employee (or independent contractor) or his designated beneficiaries at a specific time or upon a specific event, commonly death, disability or retirement. An employer's obligation under the NQDC is a liability which reduces the value of the business. A NQDC is not funded. To finance their obligations under a NQDC plan with cash-free build up, employers commonly use life insurance products with investment elements. The employer may deduct amounts paid to the employee under the NQDC plan in the year the employee includes the payment in gross income. The employee can generally avoid taxation until amounts are actually or constructively received under the plan; however, this determination can be complicated. The death benefit payable to an employees' beneficiary is included in an employee's gross estate under I.R.C. § 2039.

3. Taxation. In general, the tax consequences discussed below are applicable to all life insurance policies owned by a business.

(a) Premiums Not Deductible. Premium payments are not deductible even though the life insurance serves a business purpose. I.R.C. § 264.

(b) Income Tax. The proceeds received by the business are usually not taxable to the business. I.R.C. § 101(a); Treas. Reg. § 1.101-1(a). However, a portion of the proceeds may be taxable under the "transfer for value" rule. I.R.C. § 101(b). In most cases, proper planning can limit the effect of the transfer for value rule.

(c) AMT. A C-Corporation's alternative minimum tax (AMT) liability may be increased by receipt of the life insurance proceeds.

(d) ACE Tax. Receipt of life insurance proceeds may also subject a C-Corporation to the accumulated earnings (ACE) tax under I.R.C. § 531. The ACE tax is designed to discourage C-Corporations from retaining earnings and profits to avoid or defer income tax on amounts otherwise distributed to shareholders. The ACE tax imposes a 28% surtax on earnings and profits accumulated in excess of the greater of (1) $250,000, or (2) the reasonable needs of the business.

(e) Key Shareholders as Insured. Proceeds paid to a corporation are not included in the gross estate of the insured shareholder as the corporation's ownership is not imputed to the insured. Treas. Reg. § 20.2042-1(c)(6). However, to the extent the proceeds are not paid to the corporation (or its creditors) they will be included in the gross estate of an insured shareholder who is a sole or controlling (by vote) shareholder. Id. In addition, in general, the receipt of proceeds by the business increases the value of the business. Treas. Reg. §20.2031-2(f). In theory, this increase should be a wash out if the amount of insurance was accurately tied to the estimated businesses losses generated by the death of the key employee. Unfortunately, it may be difficult to quantify the economic effect of a key employee's death.

(f) Key Partners as Insured. Proceeds paid to a partnership are not included in the gross estate of the insured partner but they will increase the value of the partner's partnership interest for estate tax purposes. Estate of Knipp v. Commissioner, 25 T.C. 153 (1955), *acq*. Rev. Rul. 83-147, 1983-2 C.B. 145, *aff'd on other issues*, 244 F.2d 436 (5th Cir. 1956), *cert. denied*, 355 U.S. 827. However, the IRS has ruled that proceeds will be included in the gross estate of the insured partner if the proceeds are paid to someone other than the partnership (or its creditors), regardless of whether the insured was a majority owner. Rev. Rul. 83-147, 1983-2 C.B. 145. The IRS is imputing the partnership's ownership interests to the insured partner when the partnership does not receive the proceeds.

B. GIFTS OF BUSINESS INTERESTS.

1. General. Many business owners desire to gift their business to the next generation. These owner's must decide (a) when to give away the business, at their death or during their life, and (b) whether the gift should be outright, in trust, or otherwise.

2. Testamentary vs. Inter Vivos Gifts.

(a) Testamentary Gifts.

(i) Advantages. There are two commonly perceived advantages to testamentary gifts:

(A) Control. A testamentary bequest permits the owner to maintain control over the business and the income therefrom during his lifetime.

(B) Basis Step-Up. In general, if the decedent’s death occurs in 2011 or thereafter, the beneficiary's adjusted basis in the business interest will be the fair market value of the interest on the owner's date of death. I.R.C. § 1014. If death occurs in 2010, the carryover basis regime of I.R.C. 1022 will apply.

(ii) Disadvantages.

(A) Inclusion in Gross Estate. The date of death value of the business will be included in the decedent's gross estate and may offset any income tax advantage of the basis step-up under I.R.C. § 1014. Since a business interest is typically a capital asset, testamentary gifts often trade a capital gains liability, typically at a 15% federal rate (plus an additional state tax), for a higher estate tax liability between a 39% to 49% rate.

(B) Tax Inclusive. Estate tax is tax inclusive in that the owner must usually pay estate tax on the money used to pay the estate tax. To avoid this effect, consideration should be give to using life insurance owned by an ILIT to pay estate tax.

(C) Loss of Appreciation and Income Shifting. The owner loses the ability to shift income to lower brackets and enhance the overall economic benefits to the family. Furthermore, the donor loses the ability to shift appreciation to the next generation free of transfer taxes.

(D) Non-Tax Effects. The owner may limit or lose the ability to ease the transition of control and management to the next generation.

(b) Inter Vivos Gifts. In general, a gift is a complete transfer of all an owner's interest in an asset for no consideration. If the transferee provides consideration, the transfer will be a part-sale and part-gift.

(i) Applicable Exclusion Amount, Annual Exclusion and Marital Deduction.

(A) Applicable Exclusion Amount. Individuals may make gifts up to the applicable exclusion amount ($1,000,000 in 2010) without having to pay gift tax.[6]

(B) Annual Exclusion. Individuals may annually make "present interest" gifts of $13,000 (adjusted for inflation) to any number of individuals free of gift tax. I.R.C. §2503(b). This is commonly referred to as the annual exclusion. Spouses can split gifts and effectively transfer up to $26,000 per individual. I.R.C. §2513(a). Annual exclusion gifts do not reduce an individual's $1,000,000 applicable exclusion amount. However, amounts in excess of $13,000 (or the adjusted amount) will reduce the applicable exclusion amount and necessitate the filing of a gift tax return (Form 709).

(C) Marital Deduction. The marital deduction may be used to transfer interests between spouses to fully utilize each spouse's applicable exclusion amount and GST exemption.

(ii) Advantages of Inter Vivos Gifts.

(A) Exclusion From Gross Estate. Outright gifts reduce the size of the gross estate. The value of the transferred asset, along with the post gift appreciation, will be excluded from the owner's gross estate. In addition, any gift tax paid on the gift will be excluded from the transferor's gross estate provided the owner survives the transfer by three years. I.R.C. § 2035(d). Thus, a lifetime gift often results in less transfer tax being

---

[6] The table below sets forth both the applicable exclusion amounts (for estate and gift tax purposes):

Year:	Applicable Exclusion Amount (death)	Applicable Exclusion Amount (gift)
2010	no estate tax	$1,000,000
2011 and thereafter	$1,000,000	$1,000,000

incurred than testamentary gifts. This results because gift tax is computed on a tax exclusive basis; gift taxes paid are not included in determining the amount of the taxable lifetime transfer.

(B) Adjusted Taxable Gifts. Outright inter vivos transfers serve as an estate freezing technique because they are generally included in adjusted taxable gifts at their date of gift value provided that the gift tax statute of limitations under I.R.C. § 6501(a) has expired and the value of gift was adequately disclosed on the gift tax return. I.R.C. § 2001(f). The gift tax statute of limitations does not start running unless the gift is adequately disclosed on the gift tax return. I.R.C. § 6501(c)(9). Thus, by adequately disclosing the gift, it can not be revalued for gift or estate tax purposes after the gift tax statute of limitations has expired.

(C) Tax Free Gifts. Use of the annual exclusion amount allow assets to be transferred free of transfer taxes.

(D) Maximizing Discount Valuations. Lifetime gifts are also preferable because they more fully utilize valuation discounts such as lack of marketability, lack of control and minority interests.

(1) Value Gift Transferred. This occurs because gift tax value is determined by the value of interest in the hands of the transferee. No attribution among family members is taken into account for valuing a gift of a business interest. Rev. Rul. 93-12, 1993-1 C.B. 202. In fact in PLR 9449001, the IRS actually permitted an owner who gifted 100% of a corporation to eleven different persons to take a minority discount for each gift. *See also*, PLR 9432001 (gift of 49% interest to 51% interest holder qualified for minority discount).

(2) Whole Valued at Death. In contrast to gifts, all interests in an entity held by the decedent at death are aggregated to determine the gross estate value. Interests included in the decedent's gross estate under other statutes (i.e. I.R.C. § 2044), however, are not aggregated with interests owned directly by the decedent. *See* Estate of Bonner v. Commissioner, 84 F.3d 196 (5th Cir. 1996); Estate of Mellinger v. Commissioner, 112 T.C. 26 (1999). In contrast, the amount of the marital deduction is determined by value of the asset in the hands of the surviving spouse. The courts appear to be split on whether these values must match, however, most of the authority tends to favor differing values. *See* Ahmanson Found v. United States, 674 F.2d 761 (9th Cir. 1981); Chenoweth v. Commissioner, 88 T.C. 1577 (1987); But *See* Provident National Bank v. United States, 581 F.2d 1081 (3rd Cir. 1978).

(3) Discount for Owner's Interest. The owner's remaining interest may qualify for discount valuations if sufficient interests are transferred during his life to reduce the owner's interest below 50%. Furthermore, the effect of a control premium is diminished if the owner's overall interest is less.

(E) Income Shifting. Lifetime gifts facilitate shifting post-gift income to lower family income tax brackets.

(F) GST Planning. The $1 million exemption (adjusted for inflation) from generation skipping transfer (GST) tax can be leveraged by allocation at time of transfer

(iii) Disadvantages of Inter Vivos Gifts.

(A) Loss of Control. Clients must understand that they no longer own or control the transferred interest. However, loss of control may be reduced by (1) transferring nonvoting interests or (2) using trusts to facilitate the transfer.

(B) Loss of Income. The owner's income from distributions may be reduced by the transferred interests.

(C) Carry-Over Adjusted Basis. The transferee receives the transferor owner's adjusted basis in the business interest (or a fair market value basis for purposes of determining loss if owner/transferor's basis is less than fair market value). I.R.C. § 1015. As explained above, this may just be trading a 39% to 49% estate tax liability for a 15% capital gain liability.

3. Special Considerations for Inter Vivos Gifts. Business interests are subject to the general rules applicable to all inter vivos gifts. However, a few rules merit particular attention.

(a) Retained Interests Under I.R.C. §2036(b). Most practitioners are aware of I.R.C. §2036(a)(1) which requires a decedent's gross estate to include property transferred during life over which the decedent retains possession, enjoyment or the right to income. However, practitioners must be aware of the impact of I.R.C. §2036(b) on transfers of business interests.

(i) General. I.R.C. § 2036(b) provides that retention of the right to vote (directly or indirectly) shares of a controlled corporation is considered a retention of enjoyment of the transferred property under I.R.C. §2036(a)(1). Accordingly, an owner's gross estate will include the value of the transferred shares in a controlled corporation if the owner retains the right to vote the shares.

(ii) Controlled Corporation. A corporation is controlled if any time after the transfer and within three years of the owner's death, the owner owned or had a right to vote stock possessing at least 20% of the total combined voting power of all classes of stock. I.R.C. §2036(b)(2); Prop. Reg. §20.2036-2(d). The attribution rules of I.R.C. §318 apply for these purposes. Id.

(iii) Nonvoting Stock. There is no inclusion if the transferred stock has no voting rights or if the donor has not retained voting rights in the stock transferred. Prop. Reg. §20.2036-2(a); Rev. Rul. 81-15, 1981-1 C.B. 467. Thus if a person owning 100% of the voting and nonvoting stock of a corporation transfers the nonvoting stock, there is no inclusion under I.R.C. §2036(b) even if the owner retains all the voting stock.

(iv) Indirect Right to Vote. Indirect retention of the right to vote stock can trigger inclusion under I.R.C. 2036(b). Such indirect retention would include the right to vote in a fiduciary capacity as a trustee, co-trustee, or officer of a corporation. Prop. Reg. §20.2036-2(c). Unlike determining control, the attribution rules of I.R.C. §318 are not to be used to attribute the retention of voting rights to the decedent. Id. Therefore, the fact that a relative of the decedent is trustee of a trust to which the decedent has transferred stock shall not in itself require a finding that the decedent indirectly retained the right to vote that stock. Moreover, voting power is deemed retained if there is any agreement with the decedent, express or implied, that the shareholder (or other holder of the power to vote stock) either will vote the stock in a specified manner or will not vote the stock. Prop. Reg. §20.2036-2(c).

(b) I.R.C. §2701. I.R.C. §2701 was enacted to prevent perceived abuses of estate freezes. It determines both (A) whether a transfer of an interest in a corporation or partnership to or for the benefit of a family member of the transferor's family is a gift, and (B) the value of the gift. If I.R.C. §2701 applies, the value of the transferred property may not be reduced by the value of any interests retained by the transferor (and applicable family members) unless the donor rights are "qualified payments". If the retained interest is not a "qualified payment" the donor's retained interest will be valued at zero. The rules of I.R.C. §2701 are technical and can be difficult to work with.

(i) Effect. The practical effect of I.R.C. §2701 is to require the business to pay a market rate dividend on preferred stock (or its partnership equivalent) if the preferred stock is to represent any value of the business, and therefore, reduce the value of transferred common stock.

(ii) Exceptions. I.R.C.§2701 is not applicable to various retained interests including: (1) interests for which market quotations are readily available. I.R.C. §2701(a)(2)(A); (2) interests that the transferor retains which are the same as the transferred interests. I.R.C. §2701(a)(2)(B); (3) interests which differ from the transferred interest only in voting rights. I.R.C. §2701(a)(2)(C).

(c) I.R.C. §83. I.R.C. §83 addresses the tax consequences of property transferred to employees in connection with the performance of services. A transfer by a shareholder to a key employee for the performance of services is taxable income to the employee; the transfer is deemed a capital contribution to the corporation and then a transfer by the corporation. Treas. Reg. §1.83-6(d). Intra-family gifts should not fall under I.R.C. §83 because the transfer is usually made on account of the family relationship and not the performance of services. However when the recipient family member is also an employee, it is not entirely clear whether the transfer is a gift or in connection for services. If the payment is for the later, the employee family member may incur unanticipated taxable income.

(d) GRAT. A gift tax efficient means of gifting property involves a grantor-retained annuity trust ("GRAT") under the provisions of I.R.C §2702(b)(1). A GRAT is an irrevocable trust to which the owner transfers property and retains the right to fixed payments for a term of years. After the term ends, the trust corpus is held in trust for, or distributed to, designated beneficiaries. The GRAT must include specific language required by the regulations under I.R.C. §2702(b). A GRAT avoids application of I.R.C. §2702(a)(2)(A) which values the owner's retained interest at zero. Instead, the owner's retained interest is valued under I.R.C. §7520 and the remainder interest (the gift) is computed by subtracting the value of the owner's interest from the total value of the transferred property.

C. INSTALLMENT SALES.

1. General. Owners sell ownership interests to family members rather than gifting them for many reasons such as: the owner (a) needs the cash flow, (b) wants children to earn the ownership interest, and (c) desires to facilitates equality among children. Since children commonly do not have the funds to pay cash for the ownership interest, the sale is structured in a manner to permit the purchase price be paid over time through various techniques including an installment sale.

2. Structure. The owner sells the business interest to the family member in exchange for a promissory note.

3. Income Tax Considerations.

(a) Gain on Sale. The owner will realize gain or loss on the sale of a business interest to the extent the amount realized exceeds the owner's adjusted basis. I.R.C. §1001. The gain will generally be a capital gain subject to the 15% tax rate.

(i) Installment Sale Treatment. The owner can report the gain under the installment method of I.R.C. §453 if at least one payment is received after the year of sale. I.R.C. §453(b)(1). Under the installment method, gain is typically recognized as payments are made under the installment obligation spreading the gain over a period of time. Under I.R.C. §453(a), an installment sale (e.g. a least one payment is made after the year of sale) must be reported under the installment method unless the taxpayer elects for it not to apply. I.R.C. § 453(d). A portion of each payment will constitute (1) a return of basis, (2) capital gain, and (3) interest. The gain element is computed by multiplying the installment payments for the year by the gross profit ratio (gross profit divided by contract price). I.R.C. § 453(c); Treas. Reg. § 15A.453-1(b)(2)(i).

(A) Exceptions to the Installment Method. The installment method is not available to: (1) sales of depreciable property between related persons unless it is established to the Secretary that principal purpose of the disposition is not tax avoidance, I.R.C. §§453(g)(1) and (2); and (2) sales of publicly traded stock or securities. I.R.C. §453(k)(2)(A).

(B) Subsequent Sale by Related Party. When an installment sale is between related parties, a resale by the original purchaser can have adverse tax consequences to the original seller. If the related person resells the property within two years after the purchase, a portion of the remaining gain on the original sale must be recognized by the original seller. I.R.C. §453(e)(1). The amount recognized is limited to the consideration the second transferor receives in the year the resale occurs. I.R.C. §453(e)(3). No reorganization is required if the issuing corporation redeems the business interest from the original purchaser. I.R.C. §453(c)(6)(A).

(1) Related Person. The term "related person" for this purpose is (1) a spouse, child, grandchild, or parent, (2) a partnership in which the original seller is a partner, (3) a trust or estate of which the original seller is a beneficiary, or (4) a corporation owned 50 percent or more by the original seller. I.R.C. §§453(f)(1) and 318(a). Notice the original seller's siblings, nieces and nephews or spouse of a child or grandchild are not related persons.

(2) Effect. This rule generally poses little concern in most family businesses. Purchasing family members typically will not resell the business interest. However if a sale occurred, the owner would need cash to pay the accelerated tax. Accordingly, it is usually advisable for the installment note from the original purchaser to contain an acceleration clause in event of a sale.

(ii) Disposition of Note. Unreported gain in a note is realized upon disposition of a note. I.R.C. § 453B. Most permanent transfers (including gifts) are dispositions. Rev. Rul. 55-757, 1955-2 C.B.557. However transfers to a revocable trust are not dispositions, Rev. Rul. 74-613, 1974-2 C.B.13, nor are certain transfers between spouses incident to divorce, or transfers on account of death. *See* I.R.C. §§ 453B(g) and (c).

(iii) Death During Term of Note. The income tax consequence of a disposition of an installment note at death turns on (A) who is the distributee, and (B) the type of disposition.

(A) Distribution to Non-Obligor. If the installment obligation is not returned to the obligor, generally the noteholder's death alone is not an event which triggers recognition of the unreported gain inherent in the note. I.R.C. §§ 453B(c) and 691(a)(4). Instead, the beneficiary to whom the note is distributed will continue to recognize gain over the remaining term of the installment obligation. The unrecognized gain is respect to a decedent ("IRD"). I.R.C. § 691. If the installment obligation is distributed to a person other than the obligor in satisfaction of a pecuniary bequest (i.e., a specific dollar amount), the decedent's estate must recognize all unreported gain. I.R.C. § 691(a)(8). The estate will receive a partially offsetting IRD income tax deduction for the federal estate tax attributable to the gain. I.R.C. § 691(c)(1)(B).

(B) Distribution to Obligor. If the installment obligation is bequeathed or devised to the obligor, the decedent's estate must recognize the unreported gain. I.R.C. § § 453(B)(f) and 691(a)(5). This rule also applies to a cancellation by will or by the decedent's executor. Id. The estate will receive a partially offsetting IRD income tax deduction for the estate tax. I.R.C.§ 691(c)(5).

(b) Income Tax Consequences to the Buyer.

(i) Basis. The purchaser's basis in the acquired business is equal to the purchase price if it is not in excess of the fair market value at the time of the transaction. I.R.C. § 1012. This is preferable to a private annuity where the transferee's basis is not fixed until the death of the transferor.

(ii) Deductibility. The obligor may deduct interest payable on the note to transferee/payor but subject to investment income limitations. However if S corporation interests are involved, deductibility will not be subject to investment income limitations if the transferee is materially participating in S corporation. C corporation and other business interests are investment interests subject to applicable limitations.

4. Transfer Tax Considerations. The installment note effectively "freezes" the value of the underlying business interest as of the date of transfer.

(a) Gift Tax. No taxable gift will result as long as the installment note is for the full value of the transferred business interest and bears appropriate interest. Obviously, the business interest must not be undervalued. The interest rate of the installment note should usually be the AFR. I.R.C. § 1274. A 6% rate is applicable to intra family sales of real property under $500,000. I.R.C. §§ 483(e) and 267(c)(4).[7]

(i) Cancellations of Annual Exclusion Amount. Annual cancellation of payments under an installment note can arguably qualify for annual exclusion, but the owner will recognize gain upon cancellation and report interest income. I.R.C. §§ 453B(f)(1) and 453(a). *See also*, Haygood v. Commissioner, 42 T.C. 936 (1964); Estate of Kelley, 63 T.C. 321 (1974); Rev. Rul. 77-299, 1977-2 C.B. 343.

(b) Estate Tax.

(i) Underlying Asset. The transferred business interest is excluded from the owner's gross estate along with post-sale appreciation in excess of the note's interest rate. I.R.C. §§ 2702 and 2036(a) do not apply since the transferor has not retained the "income from the transferred property." The fact that the installment obligation is secured by the transferred business interest should not alter this result. *See* Commissioner v. Brown, 380 U.S. 563 (1965), *but See* Prop. Reg. § 20.2036-2(a).

---

[7] In Krabbenhoft v. Commissioner, 94 T.C. 87 (1990), aff'd 939 F.2d 529 (8th Cir. 1991), the Tax Court and the Eighth Circuit held that the § 483 (income tax) safe harbor rate did not apply to valuation issues in connection with the transfer tax. The Seventh Circuit reached a different conclusion in Ballard v. Commissioner, 854 F.2d 185 (7th Cir. 1988). The Tenth Circuit has also held that § 483 is not applicable for gift tax valuations. Schusterman v. United States, 63 F.3d 986 (10th Cir. 1995). These cases dealt with tax years prior to the 1984 enactment of § 1274. Cf. Lundquist v. United States, 1999 U.S. Dist. Lexis 3042, 99-1 USTC ¶ 60,336 (N.D.N.Y. Feb. 23, 1999). In Frazee v. Commissioner, 98 T.C. 554 (1992), the Tax Court stated that § 1274 also does not apply for gift tax valuations. The § 7520 rate may be a reasonable alternative to the § 1274 rate that is administratively acceptable as a starting point for transfer tax valuations involving a SCIN.

(ii) Installment Note. If transferor dies while the installment note is outstanding, the note is included in the holder's gross estate at its face value. A lesser amount may be claimed if: (a) the note's interest rate is below the market rate at the time of the transferor's death, (b) the maturity date is unfavorable, (c) the security is insufficient or (d) the debtor is insolvent. Of course, the IRS could then respond that (a) the decedent received less than full and adequate consideration for the sale causing inclusion of the transferred interest under I.R.C. § 2036, 2037 or 2038, *See* Estate of Robinson v. Commissioner, 69 T.C. 222 (1977), or (b) the decedent made an unreported gift requiring the filing of late gift return and possible imposition of penalties. *See*, Ballard v. Commissioner, 854 F.2d 185 (7th Cir. 1988); Krabberhoft v. Commissioner, 939 F.2d 529 (9th Cir. 1991).

(c) Generation Skipping Transfer Tax. Unlike GRATs installment sales work well for GST planning. If there is no gift component (i.e., because the note value equals value of transferred property), there is no GST issue. Thus, a client could enter into a transaction of unlimited value with a skip person without using any GST exemption. However, if gift is later assessed, late allocation of GST exemption will be necessary. If there is a gift, there is no estate tax inclusion period ("ETIP"), so GST exemption can be allocated to the gift at the time of transfer which effectively allows the transferor's GST exemption to be leveraged. Arguably, a small gift should be made so that a fractional GST allocation can be made at the time of the sale.

5. Other Uses of Installment Sales. Variations of the installment sale technique include: (a) self canceling installment notes ("SCIN"); (b) installment sales to intentionally defective grantor trusts ("IDGT"), (c) installment sales to IDGT with a SCIN, and (d) private annuities.

(a) SCINs. A SCIN is simply an installment note which contains a provision extinguishing the obligation to pay upon the death of the note holder (e.g., the seller). The termination feature of a SCIN makes it similar to a private annuity. In fact, the IRS position is that a SCIN is a private annuity if the actuarial life expectancy of the holder/seller is less than the term of the note. G.C.M. 39504

(i) Estate Tax Benefit. A SCIN is used primarily for its estate tax benefit. Since the SCIN is cancelled on death, no further payments are due and its value in the holder/seller's gross estate is zero. Estate of Moss v. Commissioner, 74 T.C. 1239 (1980) *acq. in result*, 1981-1 C.B. 2. *See* also, Estate of Frane v. Commissioner, 98 T.C. 341 (1992), *aff'd in part and rev'd in part*, 93-2 USTC ¶ 50,386 (8th Cir. 1993); G.C.M. 39503.

(ii) Gift Taxes. As with a straight installment sale, a sale with a SCIN will not be a gift if the value of the SCIN equals the value of the property sold. However, the value of the SCIN must take into account the possibility of the holder/seller's death. A gift will result if the SCIN does not contain a risk premium to offset the self-cancellation feature. The risk premium may be reflected by an increase in the interest rate or the principal of the SCIN. While there is no clear guidance on how to compute a sufficient risk premium, it is usually determined by reference to the seller's actuarial life expectancy at each payment.

(iii) Income Tax Considerations. The ordinary installment sale rules apply to a SCIN. *See* Temp. Regs. §15A.453-1(c). Death of the seller/holder constitutes a disposition of the SCIN. The IRS takes the position that the estate of the seller/holder must recognize all unrealized gain as IRD under I.R.C. §§453B(f)(1) and 691(a)(2). Rev. Rul. 86-72, 1986-1 C.B. 253. This position has been upheld by the 8th Circuit in the Estate of Frane v. Commissioner, 93-2 USTC 50386 (8th Cir. 1993) which reversed the Tax Court's holding that the unrealized gain is recognized on the seller/holder's final income tax return. Estate of Frane v. Commissioner, 98 T.C. 341 (1992).[8] The purchaser's basis in the acquired property is its cost. The basis is not reduced due to the seller/holder's death. Estate of Frane v. Commissioner, 93-2 USTC ¶ 50,386 (8th Cir. 1993).

(iv) Other Concern. The SCIN must have economic reality. For example, a purported SCIN was held to be a taxable gift where the (A) seller was in poor health at the time of sale (and in fact died one month later), (B) the purchaser had no financial assets from which to make the payments, and (C) note was interest free, payable on demand, and unsecured. Musgrove Estate. v. U.S., 33 Fed. Cl. 657 (Fed. Cl. 1995).

(b) Installment Sale to IDGT.

(i) Purposes. Owners are often reluctant to transfer equity interests outright to children for many reasons including: (i) children's inability to manage the interest due to minority or otherwise; (ii) preventing a dilution of control, and (iii) not wanting cash to pass directly to children if the business is eventually sold. An installment sale to and IDGT is an effective method to plan for these concerns in an efficient transfer tax and income tax manner.

(ii) Overview of Technique. Under this technique, the owner sells his business interest to an IDGT in exchange for a promissory note. The IDGT is an irrevocable trust which is structured to be excluded from the owner's gross estate for estate tax purposes (by avoiding application of I.R.C. §2036, 2037 and 2038) but is treated as a grantor trust for income tax purposes. *See* Treas. Reg. § 1.675-1(b)(4). Therefore, no gain or loss is recognized on the sale and the value of the transferred asset is frozen for estate tax purposes as all post transfer appreciation in excess of the interest rate on the promissory note passes to the beneficiaries of the IDGT free of estate tax.

(iii) Income Tax Considerations.

(A) No Recognition of Gain on Sale. Because the trust is a grantor trust, no gain is recognized on the sale from the owner to the IDGT. Rev. Rul. 85-13, 1985-1 C.B. 184.

(B) IDGT Basis. Since the initial sale to the IDGT is not recognized for income tax purposes, the IDGT's basis in the purchased asset is the same as

[8] The dissent in this case provides factors to support an argument that no portion of the unrealized gain is taxable to the estate or the decedent.

the owner/grantor's basis. Furthermore, the IDGT's assets do not receive a step-up basis under I.R.C. §1014 because they are not included in the decedent's gross estate. However, owner/grantor may be able increase the basis of the trust assets by exchanging high basis assets (such as cash) for the trust's assets prior to death (i.e., substituting assets of equivalent value in a non fiduciary capacity. I.R.C. § 675(4)(c)).

(C) Death During Term. Since the sale to a grantor trust is actually treated as a sale to one's self, the tax consequences of the owner/grantor's death during the term of the installment note are unclear. It appears that the change in grantor trust status causes gain to be recognized by the deceased owner/grantor (absent a cancellation). *See* Treas. Reg.§1.1002-2(c), Example (5); Madorin v. Commissioner, 84 T.C. 667 (1985); Rev. Rul. 77-402, 1977-2 C.B. 222. This position is appropriate if the grantor trust status ceases during the grantor's life. If grantor trust status instead ends by reason of the owner/grantor's death, it is more logical that the estate report the gain as an item of IRD under I.R.C. §691. QUERRY: If the estate reports the gain, does the trust then obtain an income tax basis equal to fair market value which would offset any gain?

(D) Taxation of Trust Income. The grantor status of the IDGT will cause the grantor will be taxed on all income of the IDGT regardless of whether or not it is actually distributed to the owner/grantor. This requires the planner to carefully consider whether the owner has sufficient funds to pay any tax incurred by a subsequent sale of the business interest by the IDGT. Absent a right of reimbursement from the trust, the grantor's payment of income taxes reduces his or her gross estate and increases the value of the trust.

(1) Gift Tax Effect of Payment of Taxes. The seller/grantor's payment of taxes should not result in a taxable gift to the trust since the owner/grantor is personally liable for the taxes as the deemed owner of the trust assets. *See* Commissioner v. Beck's Estate, 129 F. 2d 243 (C.C.A. 1942) Doerr v. United States, 819 F. 2d 162 (7th Cir. 1987).

(2) IRS Position. The IRS' position is unclear. In PLR 9444033, the IRS ruled that a payment of taxes by the seller/grantor is a taxable gift to the trust if trust did not contain a reimbursement provision. However, in PLR 9543049, the IRS reissued its prior ruling in PLR 9444033 but deleted the language as to the additional gift from the payment of income taxes. Many commentators have inferred that the IRS is reconsidering the issue. For advanced ruling purposes, the IRS appears to require the trust to include a reimbursement provision. *See* PLR 9707027.

(iv) Transfer Tax Considerations.

(A) Estate Tax. While the fair market value of the installment note is included in the owner's gross estate, assets of IDGT should be excluded from the owner's gross estate under I.R.C. §2036(a)(1). *See* Lafargue v. Commissioner, 689 F.2d 845 (9th Cir. 1982); Stern v. Commissioner, 747 F.2d 555 (9th Cir. 1984) and Estate of Fabric, 83 T.C. 932 (1984). However, the IRS could treat a promissory note as a retained interest under I.R.C. §2036(a)(1) rather than a creditor's right particularly if the owner/grantors right to

2392591v2

payments under the installment are tied to trust income. *See* PLR 9251004. *See* also, Ray Estate v. U.S., 762 F.2d 1361 (9th Cir. 1985). The risk of inclusion under I.R.C. §2036(a)(1) may be increased if (1) the note secured by trust property; (2) the trust has little property other than the purchased assets, (3) the seller/grantor's creditors may reach the property of the trust.

(B) Other Transfer Taxes. There should be little chance of a taxable gift if the note carry's sufficient interest and equals (along with any consideration paid) the value of the transferred property. I.R.C. §§ 2701 and 2702 should also not apply since the note is debt and not an applicable retained interest in the trust or a term interest (equity). *See* PLRs 9436006; 9535026; *but See* PLR 9251004.

(c) Installment Sale to an IDGT Combined with a SCIN. This is a powerful and risky technique which combines a SCIN with an installment sale to an IDGT. The objective is to realize benefits of each technique. The seller/grantor's estate should not be required to recognize any unreported gain on the SCIN (i.e. it avoids application of Frane) because gain on the sale to the IDGT is not taxable to owner/grantor. Of course, the unreported gain would be an item of IRD under I.R.C. §691.

D. PRIVATE ANNUITY. A private annuity is another method of transferring a business interest in exchange for an income stream.

1. Basic Features. A private annuity transaction consists of a transfer of property (usually appreciated) in exchange for an income stream. A private annuity is an annuity contract for a term measured by reference to the seller's life expectancy. The rate used to value a private annuity is 120% of the applicable federal midterm rate. I.R.C. § 7520. Conceptually, a private annuity is similar to a commercial annuity. However, the tax consequences may differ when the annuity is purchased with appreciated property from a person not in the business of selling annuities.

2. Advantages. In addition to providing the owner/seller income stream for life, a private annuity provides the following advantages:

(a) Gift Tax. The establishment of a private annuity will involve a gift if the value of the transferred property is greater than the present value income stream received. Methods to value private annuities are set forth in Rev. Rul. 84-162, 1984-2 C.B.200.

(b) Estate Tax. A private annuity typically ends upon the seller/annuitant's death (and has a zero value) and is not included in the seller/annuitant's gross estate. *See*, Fidelity Philadelphia Trust Co. v. Smith, 356 US 274 (1958). If payments continue to the seller/annuitant's spouse or other persons, only the value of that interest is included in the seller/annuitant's gross estate. I.R.C. § 2039. The transferred property is also excluded form the seller/annuitant's gross estate.

(c) Generation Skipping Transfer Tax. Private annuities work well for GST tax planning because there is no ETIP period. If there is a gift element, GST exemption can be allocated to the value of the gift at the time of transfer. Even if the transaction is later deemed to be part gift, part sale, the donor may allocate GST exemption to the gift part. However, if the allocation is not timely made, it must be allocated to the property value at the time the gift tax return is filed. Of course, if there is no gift element, then there is no GST issue. Arguably, a small gift should be made at the time of the transaction so that a formula fractional allocation can be made.

(d) Income Tax Considerations.

(i) Pre-Proposed Regulations. For private annuity transactions entered into on or before October 18, 2006 (and in some cases April 18, 2007), a significant benefit of a private annuity is that it allows the seller to defer capital gain over his actuarial life expectancy, provided the obligation is not secured. Rev. Rul. 69-74, 1969-1 C.B.43. Compare this result to an installment note where gain is deferred over the term of the note.

(A) Annuity Payments. Each annuity payment consists of three parts: return of capital, capital gain and ordinary income. Rev. Rul. 69-74, 1969-1 C.B. 43.

(B) Effect of Transferor's Death. If seller outlives his actuarial life expectancy, all future payments are ordinary income (investment has been recovered and gain will have been completely recognized). I.R.C.§ 72(b)(2). However, if the seller dies prior to attaining his actuarial life expectancy, any unrecognized gain is extinguished (unlike in an installment sale or SCIN). Furthermore, if the total investment has not been recovered by the seller/annuitant's death, the seller/annuitant receives a deduction for amount of unrecovered investment on his final income tax return. I.R.C. § 72(b)(3).

(ii) Proposed Regulations. Proposed regulations issued by the Treasury Department and the IRS under I.R.C.§ 72 and § 1001 would dramatically change the income tax treatment of property exchanged for a private annuity contract. See REG-141901-05, 71 Fed. Reg. 61441 (10/18/06). While these regulations do not alter the estate or gift tax treatment of a sale of property for private annuity, they significantly alter the income tax treatment for private annuity transactions entered into after October 18, 2006 (and in some cases after April 18, 2007). In this regard, the proposed regulations would essentially require that all gain in the asset be recognized on the date of the exchange to the extent of the actuarial fair market value of the annuity contract. Thus, this could create a substantial gain for transfers of highly appreciated assets.

3. Disadvantages.

(a) Taxes.

(i) Income Taxes. For transactions entered into after October 18, 2006 (and in some cases after April 18, 2007), deferral of gain is eliminated and gain is incurred in the year in which the private annuity transaction occurs. For transactions occurring before this time, if the annuity payment obligation is secured, the annuitant must recognize a gain equal to the excess, if any, of the present value of the annuity payments to be received over the basis of the contract. *See*, Estate of Bell v. Commissioner, 60 T.C. 469 (1973); 212 Corp. v. Commissioner, 70 T.C. 778 (1978). This gain would be reported in the year of the exchange. An indirect means to protect payment of the annuity is the acquisition of a life insurance policy on the obligor's life.

(ii) Basis. The purchaser's basis constantly fluctuates. Ultimately, the purchaser's basis equals the sum of annuity payments actually paid multiplied by the payment amount. Rev. Rul. 55-757, 1955-2 C.B.557. If the purchaser sells the property during the seller's life (i.e., while the payment obligation exists), basis is computed according to the actuarial value of the annuity obligation. Subsequent payments are then treated as additional losses on the sale of property. *See* Rev. Rul. 55-119, 1955-1 C.B. 352.

(iii) Deductibility. Annuity payments are nondeductible capital expenditures. The interest component of the annuity payment is also non-deductible. *See* Dix v. Commissioner 392 F.2d 313 (1968); Kaufman's Inc. v. Commissioner, 28 T.C. 1179 (1967) *acq*. 1985-1 C.B.5; Rev. Rul. 55-119, 1955-1 C.B. 352.

(iv) Purchaser's Death. The purchaser's estate will include the value of the acquired property. However, the purchaser's estate also remains liable to continue making annuity payments to the seller. But this obligation will be a deductible debt against the purchaser's gross estate.

(v) Estate and Gift Tax Concerns. The IRS and the courts have treated an intended private annuity as a gift (at least in part) with a retained life estate, if

(A) The amount of the annuity payments were limited to or substantially the same as the income generated by the annuity property, *See* Lazarus v. Commissioner, 58 T.C. 854 (1972), *acq*. 1973-2 CB 2, *aff'd*, 513 F.2d 824 (9th Cir. 1975); Rev. Rul. 79-94, 1979-1 CB 296;

(B) The purchaser/obligor is not personally liable for the annuity payments, *See* Rev. Rul. 68-183, 1968-1 C.B. 308;

(C) The purchaser/obligor has no economic means form which to make the annuity payments, Id.; or

(D) The seller/annuitant retains control over the management of the transferred property or its disposition by the purchaser/obligor. Estate of Holland v. Commissoner, 47 BTA 807 (1942).

(b) Valuation. Valuing the transferred business interest can be difficult. If the value is incorrect a taxable gift may be made and a late gift tax return may be due.

(c) Duration of Payments. The purchaser must make fixed payments for an indefinite period, the seller's death.

E. STOCK REDEMPTIONS.

1. General. A common concern in all of the sales techniques discussed above (installment sales and private annuities) is how the purchasing family member will pay the owner/seller. If the purchaser depends upon the business to provide some or all of that cash, usually only after-tax cash will be available to reduce the debt because distributions from a corporation are usually taxable to shareholders. This concern may be limited if the business is an S-Corporation or partnership.

2. Bootstrap Transactions. To avoid (or limit) the shareholder level of tax, a "bootstrap" transaction may be used in which some of an owner's stock is generally sold or gifted to a family member, and the balance is redeemed by the corporation itself. The effect is to cause the stock in the hands of the younger generation to be the only outstanding stock.

3. Taxation of Stock Redemptions.

(a) General. Unlike a sale to an outside party, a stock redemption will be taxed as a sale of exchange of a capital asset only if it satisfies one of three tests set forth in I.R.C. § 302(b). If the stock redemption fails all the tests, then it will be treated as a dividend to the extent of the company's earnings and profits under I.R.C. §301, if the corporation is a C-Corporation. If the corporation is an S-Corporation, it will be taxable as a distribution under I.R.C. § 1368.

(b) Sale or Exchange of Tests. A stock redemption will qualify for sale or exchange treatment if any of the following tests are satisfied:

(i) Not Essentially Equivalent to a Dividend. A redemption will obtain sale or exchange treatment if it is "not essentially equal to a dividend" I.R.C. § 302(b)(1). This requires a "meaningful reduction" in the selling shareholder's proportionate interest. U.S. v. Davis, 397 U.S. 301 (1970). This test is difficult to plan for due to its subjective nature. However, some guidance can be found in favorable IRS rulings. *See* Rev. Rul. 75-502, 1975-2 C.B. 111 (interest reduced from 57% to 50%); Rev. Rul. 75-512, 1975-2 C.B. 112 (interest reduced from 30% to 24.3%); Rev. Rul. 76-364,- 1976-2 C.B. 91 (interest reduced from 27% to 22.3%). But *See* Rev. Rul. 77- 1977-1 C.B. 81 (interest reduced from 60% to 50% did not qualify). The primary utility of I.R.C. § 302(b)(1) is defensive; it is usually employed as a last line of defense.

(ii) Substantially Disproportionate Redemption - I.R.C. § 302(b)(2). This is a mechanical safe harbour test and sale or exchange treatment is permitted if the redemption is substantially disproportionate. I.R.C. § 302(b)(2)(A). The redemption is treated as a sale or exchange under I.R.C. §302(b)(2) if each of the following are satisfied: (1) the shareholder's percentage of voting stock ownership must have decreased at least 20%; (2) the shareholder's percentage of common stock ownership must have decreased at least 20%; and (3) immediately after the redemption, the shareholder must own less than 50% of the combined voting power of all classes of stock entitled to vote. Generally, the most common obstacle to satisfy I.R.C. § 302(b)(2) is the necessity to reduce the selling shareholder's voting interest below 50%. Application of the I.R.C. § 318 attribution rules is also a common stumbling block.

(iii) Complete Termination of Shareholder's Interest - I.R.C. § 302(b)(3). The redemption of all of a shareholder's stock will qualify for sale or exchange treatment. I.R.C. § 302(b)(3). However, all stock owned, directly or constructively, by the selling shareholder must be redeemed. The attribution rules of I.R.C. § 318 apply to determine stock owned by the shareholder for this purpose. If all stock actually owned by a shareholder is redeemed, I.R.C. § 302(c)(2) allows sale or exchange treatment even if the shareholder constructively owns stock (i.e., application of the family attribution rules can be waived) if the following conditions are met:

(A) No Interest in Corporation. The selling shareholder must retain no interest in corporation (including as shareholder, officer, director or employee), other than as a creditor. Note, the Tax Court has permitted a selling shareholder be retained as an employee if he does not receive "control or financial stake" in the corporation. *See* Cerone v. Commissioner, 87 T.C. 1 (1986); Seda v. Commissioner, 82 T.C. 484; Lewis v. Commissioner, 47 T.C. 129 (1966), *but See* Lynch v. Commissioner, 801 F. 2d 1176 (9th Cir. 1986), *rev'g* 83 T.C. 597 (1984) (rejecting control or financial stake test)

(B) Ten-Year Limit on Future Acquisition. The selling shareholder does not acquire any interest (e.g., shareholder, officer, director or employee) in the corporation for 10 years following the redemption (except by gift or bequest).

(C) Notice to Service. The selling shareholder agrees to notify the IRS if it acquires an interest described in (2) above.

(D) No Tax Avoidance. During the ten-year period before the distribution, no stock has been acquired from or transferred to a related person in a transaction having as its principal purpose the avoidance of Federal income tax I.R.C. § 302 (c)(2)(B). Gifts for estate planning purposes (to reduce the size of the estate) are permissible, PLR 9023047, as are gifts to insure the continuity of management. Rev. Rul. 77-293, 1977-2 C.B. 91.

4. Other Considerations.

(a) Attribution Rules. If as part of a bootstrap transaction stock is gifted stock to a child or grandchild, the redemption would have to come under the "complete termination of interest" of I.R.C. § 302(b)(3) to qualify for sale or exchange treatments. Furthermore, the family attribution rules would also have to be waived.

(b) Gift Tax Considerations. The purchase price for the redeemed stock should be its fair market value, or an indirect gift to the other shareholders could result. When valuing the redeemed stock, discounts may not be appropriate. *See* PLR 9504004.

(c) Installment Notes. It is important that business cash flow not be impaired by the redemption. The Company may redeem the stock for an installment note payable over a long period of time. *See* Rev. Rul. 57-295, 1957-2 C.B. 227. The IRS has approved use of a 10 to 15 year balloon installment note. *See* PLR 8214042; PLR 8204159. However, use of a balloon note could raise a debt versus equity issue under I.R.C. §385.

(d) Security. The IRS will not issue a private letter ruling if the redeemed stock is hold in escrow or as security for payment of a note and the stock may be returned to the selling shareholder. Rev. Proc. 96-3, 1996-1 I.R.B. 82, § 3.01(16). However, there is authority to support placing redeemed stock in escrow or using it as security for a note. *See* Lisle v. Commissioner, 35 T.C.M. 627 (1976) (stock escrowed); Lynch v. Commissioner, 83 T.C. 597 (1984), *rev'd on other grounds*, 801 F.2d 1176 (9th Cir. 1986) (notes secured by other shareholder's stock); Mathis Estate v. Commissioner, 47 T.C. 248 (1966) *acq.*, 1967-1 C.B.2 (stock in escrow); Hoffman v. Commissioner, 47 T.C. 218 (1966), *aff'd per ruriam*, 391 F.2d 930 (5th Cir. 1968) (stock pledged as security).

F. SPIN-OFFS, SPLIT-OFFS, SPLIT-UPS.

1. General. Some families own multiple businesses. In this circumstance, a succession plan can be tailored to have each child receive a different business. Family businesses that are operated within a single entity or owned by a single entity can be divided into separate corporations in a tax-free division under I.R.C. § 355 (an income tax statute). Other assets can be used to achieve any desired equalization among family members.

(a) Overview. A corporate division is a transaction in which a single corporate enterprise is divided into two or more separate corporations that remain under the same ownership. A division is accomplished when a parent corporation (the distributing corporation) distributes stock or securities of one or more controlled subsidiaries to its shareholders.

(b) Tax Consequences. If various statutory and judicial requirements are met, the transaction is tax-free to the distributing corporation and its shareholders. See I.R.C. § 355. To the contrary, if these requirements are not satisfied, the transaction will be taxable to both the distributing corporation and to the shareholder under the general tax rules addressing distributions and redemptions.

G. CHARITABLE LEAD TRUSTS.

1. Terms of a CLT.

The trust agreement provides that the Trustee must make annual payments to one or more qualified charities during a term of years or the lives of one or more individuals. The remainder generally passes to designated members of the donor's family. The charitable interests can either be an annuity or unitrust (fixed percentage) amount.

The CLT can be created during lifetime or at death. An inter vivos CLT can be structured as a "grantor" trust or as a taxable trust. If the CLT is structured as a taxable trust, its income and gains will be subject to tax although its distributions qualify for the unlimited income tax charitable deduction, thus avoiding tax on the amounts distributed to charity.

Capital gains taxes would thus be paid upon the conversion of appreciated assets to other investments. There is no income tax deduction when a CLT is funded unless it is a grantor trust.

Charitable lead trusts are subject to certain private foundation rules. Self-dealing rules apply under IRS § 4941, and if the value of the charitable interest for gift tax purposes exceeds 60 percent of the initial value of the trust, then it is also subject to the excess business holding rules of Code § 4943 and the Jeopardy Investment Rules § 4944. Those rules can end up making it difficult for the trust to hold interests in a closely held business.

The testamentary CLT, structured as an annuity trust, is the most frequently used CLT.

2. <u>Planning Use</u>

If the value of assets placed in the CLT can be discounted or will appreciate at a rate in excess of the federal discount rate, significant estate taxes and gift taxes can be saved. For example, when the federal discount rate was 8.2 percent, an annuity payout rate of 10 percent for 20 years gave rise to a deduction of 99 percent of the fair market value of the assets for gift tax purposes. In October of 1998 the federal discount rate was 6.2 percent, so an annuity payout rate of 8.6 percent for 20 years resulted in a 99 percent deduction for the charitable gift.

PLR9631021 approved a formula approach to prescribe testamentary charitable lead payments by one of two alternate formulas that could be selected within nine months of the date of death. The Will of the taxpayer declared the intent to have an election made that resulted in the largest charitable deduction.

PLR 9810019 and PLR 9642039 have apparently approved a grantor trust/CLT that will not be includable in the grantor's estate. For donors who can use the deduction up front, this may become a very popular planning tool as long as federal discount rates stay low.

Caveat: The IRS will not rule on whether grantor trust status is obtained for income tax purposes if the triggering defective power is dependent upon facts and circumstances (i.e., use of Section 675(4)(c) power to reacquire trust corpus by substituting property of an equivalent value, exercisable in a non-fiduciary capacity).

H. <u>CHARITABLE REMAINDER TRUSTS</u>

1. <u>Definition of Unitrust and Annuity Trust</u>

A CRT is an irrevocable trust which must pay a defined annual amount to specified noncharitable beneficiaries for a definite period, at the end of which the trust property is transferred to one or more permissible charitable recipients. Section 664. A fixed percentage (5% or more) of net fair market value of trust assets determined annually ("the unitrust amount"), must be paid. The trust can provide that the lesser of the unitrust amount or trust income (as defined in Section 643(b)) be paid. The trust can also provide that if income is less than unitrust amount in any year, the deficiency can be made up out of trust income in excess of the unitrust amount in a subsequent year. The trust may also pay a fixed dollar amount (at least 5%) of initial fair market value of trust assets ("the annuity amount").

The 1997 Tax Act made two important changes with respect to CRTs.

Mandatory 10% Charitable Remainder Interest The present value of the remainder in a CRT must be at least 10% of the net fair market value of the property as of the date that the property is contributed to the trust. The new 10% rule is effective for transfers in trust after July 28, 1997 but does not apply to transfers in trust under a will or other testamentary instrument executed on or before July 28, 1997, if the decedent dies before January 1, 1999, without having changed the document, or if it could not be modified because the decedent was on July 28, 1997 under a mental disability.

Additions to an existing CRT are treated as the creation of a new trust for purposes of the 10% test.

50% Ceiling on Noncharitable Payments The Act now provides a 50% ceiling on the noncharitable annuity or unitrust amount. This rule is designed to rule out the use of certain very short-term charitable remainder trusts with very high annual payouts.

2. Payment Period

The income payments can be made for:

(a) The life of lives of a named individual or individuals; or
(b) A term of 20 years or less; or
(c) A permissible combinations of a and b.

When the payment period ends, the entire trust corpus must be transferred irrevocably to or for the use of one or more Section 170(c) charities.

3. Tax Consequences.

(a) Section 170. The donor is allowed in the year of transfer a deduction for the present value of charitable remainder interest, computed under IRS actuarial tables. The nature of the remainderman will affect the amount of the contribution base that is deductible.

(b) Gift Taxes. A gift tax deduction is allowed for the gift of the charitable remainder. Section 2522(a). Where the donor names a spouse as sole, concurrent, or successor beneficiary, the gift tax marital deduction is allowed for the spouse's interest. Section 2523(g). An income interest for non-spouse successor beneficiaries is a future interests and does not qualify for the present interest annual exclusion. In that case the donor should retain the right to revoke the interest, by will, to prevent a completed, taxable gift.

(c) Estate Taxes. If the donor is the beneficiary during his lifetime the entire value of trust corpus is included in his gross estate. Section 2036. An estate tax deduction is allowed for value of remainder interest at death. A continuing interest for the donor's surviving spouse qualifies for estate tax marital deduction if the donor and spouse are the only noncharitable beneficiaries. Section 2056(b)(8). The interest of any other successor noncharitable beneficiary is subject to estate tax.

(d) Taxation of Trust. A CRT is exempt from income tax for any year in which it does not receive unrelated business taxable income ("UBTI"). Reg. Section 1.664-l(a)(l)(i). (The Court of Appeals for the Ninth Circuit affirmed a tax court holding that even a very small amount of unrelated business taxable income in a charitable remainder trust will cause the trust to lose its tax exempt status and become taxable for the year in which it has the unrelated business taxable income. Leila G. Newhall Unitrust, 105 F.3d 482 (9th Cir. 1997). This may occur when a CRT holds partnership interests such as the publicly traded limited partnership involved in the Newhall case.) The annual amounts distributed to noncharitable beneficiaries will be treated as follows:

(i) First, as ordinary income to the extent of the trust's ordinary income for the year and any undistributed ordinary income for prior years;

(ii) Second, as short-term capital gain to the extent of the trust's short-term capital gains for the year and any undistributed net short-term capital gains for prior years;

(iii) Third, as long-term capital gain to the extent of the trust's long-term capital gains for the year and any undistributed net long-term capital gains for prior years;

(iv) Fourth, as other income to the extent of the trust's other income for the year and prior years;

(v) Fifth, as non-taxable distribution of principal.

The donor may retain the power to change the charitable remainder beneficiary. Rev. Rul. 76-8, 1976-1 C.B. 179. The donor may not change trustees, or serve as trustee, if the trustee has the power to allocate the annual payout among noncharitable beneficiaries.

4. <u>Creating the CRT</u>.

(a) Execute irrevocable charitable remainder trust.

(b) Transfer asset, often an appreciated long-term gain asset, to the trust, claim a charitable income tax deduction for the market value of the asset reduced by the value of the retained income interest.

(c) The charitable trust sells asset if necessary to diversify but reports no taxable gain due to its tax-exempt status.

(d) At death of income beneficiary (or after specified term of years), the property within the trust passes to the charity.

I. CHARITABLE GIFTS OF SUBCHAPTER S STOCK.

The Small Business Job Protection Act of 1996 permitted a charitable entity (not a CRT or CLT) to hold S stock without terminating the election, effective on January 1, 1998. However, there are several issues to consider:

1. Income from "UBTI".

S corporation stock income will be unrelated business taxable income ("UBTI"), as will gain from the sale of the S corporation stock. Section 1361(e) and Section 512(e). A charity is subject to UBTI on all income attributable to S corporation stock, including interest, dividends, rents and capital gains. Even the gain from the charity's sale of the S corporation stock is taxable. The charity will be taxed on its share of income, not just cash distributions.

2. State Law Issues.

The donor must remember that the charity will have the legal rights of a minority shareholder. Agreements may be advisable to prevent the charity from selling the stock to another party.

3. Deduction Limitation.

The income tax deduction for a gift of S corporation stock must be reduced under rules that are similar to charitable gifts of partnership interests. Section 170(e)(1) provides that rules similar to Section 751 shall apply in determining whether gain on stock would have been long-term capital gain if such stock were sold by the donor. Thus, a donor may have to reduce his income tax deduction by the proportion of the gain that would be treated as ordinary income if the underlying assets of the corporation had been sold. This reduction only applies to income tax deductions.