Agenda

- Introduction
- Personal Aspects of Succession Planning
- Types of Buy-Sell Agreements
- Valuation Issues
- Funding with Life Insurance
- Income Tax Considerations
  - Corporations
  - Partnerships
- Estate Tax Considerations
Less than 1/3 of family businesses survive to the next generation, and only 13% survive to the third generation.

Nobody plans to fail, they simply fail to plan!

Reasons for failure to survive can include the following:
- Improper planning for transition to next owners and/or sale of business;
- No publically established value and a limited market for sell;
- Lack of liquidity for both the estate of the deceased owner and for the business;
- Impact of transfer taxes on the business or family members;
- Conflict among the owners and/or their heirs.
Possible adverse effects

Failure to Plan leads to the following:

- Family Conflict (the kids will work it out)
- Excessive transfer taxes
- Excessive or unnecessary income taxes
- Transition to unqualified or contentious owners
- Uncertainty of leadership/management
- Loss of Value
- Complete liquidation of the business
Personal Aspects

- Perpetuation of the family business
- Family business life cycle
- Issues of succession
- Preparing a plan for ownership transition
Common Exit Strategies

The most common exit strategies (short of dissolution!) are the following:

- Sale or bequest to family members
- Sale to unrelated senior management employees
- Sale to a strategic buyer or competitor
- Sale to a financial buyer, like a private equity group
- Sale to employee stock ownership plan (“ESOP”)
Choosing a successor

- Rule of thumb is that it takes 10 years to find a successor--2 years to locate and 8 years to train
- Process for choosing successors
  - Establish priorities (business first, or family first?)
  - Evaluate family members (objectively)
  - Evaluate insiders
  - Successor Training
  - Transition – Employees
  - Transition – Customers/clients
What is a buy-sell agreement?

Trigger Provisions—include the following

- Voluntary transfers
- Disability
- Retirement
- Termination of employment
- Death
- Involuntary transfers, divorce, bankruptcy
Buy-Sell Agreements

- Benefits of a buy-sell agreement
  - To the surviving owners
  - To the Deceased’s estate and family
  - To both!
Types of Agreements

- Types of Buy Sell Agreements
  - Cross-Purchase
  - Redemption
  - Hybrid
  - Wait-and-see

- Advantages and Disadvantages
Methods for Determining Purchase Price

- Fixed dollar value
- Book value
- Certificate of value
- Appraisal value
- Agreed upon value
Valuation

- Fair Market Value—Reg. Sec. 20-2031-1(b)

- Methods of valuation include the following methods:
  - Discounted future returns
  - Capitalization of earnings
  - Industry rules of thumb
  - Asset value

- Revenue Ruling 59-60—seminal IRS guidance on valuation

- Importance of case law
Discounts

- Lack of marketability
- Minority
- Control premium
- Unique factors of the business
Penalties for valuation errors

- Accuracy Related Penalties include the following:
  - Negligence or Disregard of Rules/Regulations – 20% (Sec. 6662(b)(1)).
  - Substantial valuation misstatement – 20% (Sec. 6662(b)(3)).
  - Substantial estate or gift tax valuation misstatement – 20% (Sec. 6662(b)(5)).
  - Gross valuation misstatement – 40% (Sec. 6662(h)).
  - Fraud - 75% of the underpayment.
Insurance (Life and Disability)--by far the most common way to fund buy sell agreements, as it provide the necessary liquidity for purchase with the greatest tax advantages.

Benefits of Funded Buy-Sell Agreement

- Insurance Ownership
- Income Taxation issues
- Transfer for value rules
- Cross purchase arrangements
Other methods of funding

- Lump Sum (possibly using a sinking fund)
- Deferral
  - Income tax issues
  - Estate tax issues (Section 6166)
  - Issues of security
- Borrowing money from third parties
Income Tax Issues

- Entity type
- Characterization
- Basis
- Conflicting goals
C Corp Issues

- Entity purchase—redemption
  - Section 302 applies—general rule is redemption will be treated as a distribution
  - Exceptions to 302—key planning tool for obtaining sale or exchange treatment
  - Taxability on corporation
    - No taxes on distribution
    - Section 311 applies to distribution of appreciated property
    - Reduction of E&P
C Corp Issues

- Cross Purchase
  - Ease of administration
  - Increased basis
  - Problems of liquidity
S Corp Issues

- Entity Purchase
  - Same rules as C Corp—Section 302 applies
  - Different accounting issues for S Corp distribution—Section 1368
S Corp Issues

- Cross purchase
  - Sale or Exchange treatment for purchase
  - Increased basis of shareholders in purchased stock
Other issues for S Corporation redemptions

- One class of stock requirement—Reg. 1.1361-1(l)(2)(iii)(A)
- Election to close books (Section 1377)
Partnerships

- Entity purchase
  - Redemption under Section 736
  - 736(a) versus 736(b) Payments
  - Section 751(b)—the Hot Assets rules
Partnerships

- Cross purchases
  - Section 731 sale or exchange
  - Hot assets – Section 751. Special rule for inventory
  - Application of Section 741 to remaining amounts
Partnerships

- 754 Election
  - Result of disparity between outside basis and inside basis
  - 754 allows adjustment of these bases to avoid double tax
  - 708(b)(1)(B)—exception to the rule for sale of 50% within 12 months.
Estate Tax Issues

- Key issue: will IRS recognize the valuation?
- Estate freeze
- Treatment depends upon the year of agreement
Pre-1990 Agreements

- Reg. Section 2031-2(h)
- Four factor approach from cases
  - Obligation of Estate to sell stock at fixed price;
  - Reasonable and ascertainable price for the stock;
  - No sale by decedent at greater price;
  - The BS agreement is not a device to transfer the business interests to the natural objects of the decedent’s bounty for inadequate consideration.
Post-1990 Agreements

- Section 2703 adds requirements
  - Modification of device test
  - Comparable agreements—need for expert testimony
  - Safe harbor—Reg. 25.2703(1)(b)(3)
Post-1990 Agreements

- Significant cases on Section 2703
  - *Estate of Amlie v. Commissioner*, T.C. Memo 2006-76
  - *Holman v. Commissioner*, 130 T.C. No. 12 (2008), aff’d 105 AFTR 2d 2010-1802 (8th Cir. 2010)
Additional Estate Tax Issues

- Effect on marital deduction—PLR 9147065
- Effect on annual exclusion—*Hackl v. Commissioner*, 335 F.3d 664 (7th Cir. 2003)
- Estate tax deferral – IRC 6166
- Planning – Family and Non-Family controlled entities
Additional Resources
