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Fair Is Fair: Transitioning the Closely Held Business to the Actively Employed Child

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INTRODUCTION

While most individuals who are interested in designing an estate plan are typically focused on minimizing estate taxes as well as ensuring that assets pass according to their wishes, often with certain controls and stipulations, owners of closely held businesses have their own checklist of additional concerns. These businesses typically comprise a majority of the owner's taxable estate, which leads to analyses of efficient uses of the gift and estate exemptions and techniques such as GRATs, IDGTs, ESOPs, etc. However, of equal, if not more importance and weight, is a dialogue involving management and control of the business after the death of the parents/owners.

Anyone who has started a business has typically devoted significant time, energy and resources to the endeavor while sacrificing other aspects of his or her personal and professional life, with the focus initially on growth of revenue and stock value. As the business matures, the prudent owner should devote some of his or her focus to considering who will take over so that future generations can continue to benefit from the profits, while all family members are treated fairly regarding management and equally regarding equity.

GOAL: INCOME FOR THE SURVIVING SPOUSE

There are a few goals that the business owner would like to achieve when planning for the future. First, after the death of the owner, the surviving spouse must receive sufficient income from the business. The surviving spouse should be able to live in the same manner to which he or she was accustomed without any significant change in lifestyle. Income to a surviving spouse is the equivalent to a tangible asset whereas principal is akin to an intangible asset and of lesser concern. The fact that the company is valued at $5 million or $50 million is less important to the surviving spouse than the fact that he or she is able to draw a salary or receive dividends and be able to take the same vacations and drive the same car as he or she did when the spouse was alive.

In effect, income is how the surviving spouse measures the success of the estate plan. To do so, there are a number of assets that can be used to solve this problem if they are planned for correctly and concurrently. Also, there is a delicate balancing act here because, simultaneously, the actively employed child (or children) are handling the day-to-day operations of the business and wish to be compensated for their efforts.

Spouse Is QTIP Trust Beneficiary

Regarding the business, the ideal scenario would involve having the actively employed child draw a W-2 salary from the company and any residual profit would flow through on a Schedule K-1 (used to report the share of the partnership's income, deductions and credits) to the credit shelter and/or qualified terminable interest property ("QTIP") trust with the surviving spouse as sole beneficiary. This way, both the child and the surviving spouse are satisfied. However, in order to understand the mechanics of this technique, aspects of corporate law, trusts and estates law and tax law must be coordinated. Under corporate law, the credit shelter/QTIP trustees are the shareholders of the company. Shareholders, in turn, elect directors and directors are responsible for declaring dividends. If the actively employed child is a trustee of the QTIP trust, there is an immediate conflict of interest. The more dividends the child pays, the less working capital the child has to operate the business. On the contrary, if the child declares a small dividend, there is less income to maintain the parent's lifestyle as the deceased business owner would have wanted.

There is also a significant tax problem in having the child as trustee of the QTIP trust. According to TAM 9139001, the trust will not qualify for the marital deduction for two reasons. First, the child could direct principal to himself or herself because, as trustee and

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director of the company, the child has the power to do so. Second, the surviving spouse may not receive all of the income from the trust because the actively employed child controls the right to vote the stock and declare dividends. In order to avoid this problem, a corporate fiduciary or independent person must serve as co-trustee with the child.

Commercial Real Estate

The next source of income for the surviving spouse is commercial real estate. Typically, a number of years after acquiring the business, the owner will purchase the office real estate so that he or she pays himself or herself rent instead of to a third party. However, it is necessary to look at basic asset protection planning before using real estate as part of the succession plan.

There are basically two options as to how the building can be owned. Before 1986, the S corporation was the preferred entity of choice because it afforded liability protection and only one level of taxation. The one significant negative attribute of the S corporation is that the mortgage refinance proceeds are trapped inside the corporation and may be taxed upon distribution at the shareholder level. By contrast, the preferred entity of choice today is the limited liability company (LLC) because it has the same asset protection as an S corporation without the refinance issues.

Once the entity issue has been resolved, hopefully the business owner can avoid another landmine: common ownership of the real estate and the operating business. There is a potential liability issue if the operating business and real estate are owned by the same entity. If an individual is injured on the property and sues the business, both the company and the real estate are reachable by creditors. A tax-free spinoff[1] cannot be used in this case to separate the business and real estate into separate entities because real estate is not the conduct of an active trade or business. Therefore, as part of the planning when the building is purchased, it is imperative that a new LLC own the real estate.

Furthermore, there should be a lease between the operating business and real estate at this point. Typically, the business owner, during his or her lifetime, would sign a long-term triple net lease in which the tenant pays a fixed amount of rent with cost-of-living increases every five years or so as well as real estate taxes, insurance and maintenance or repairs. This way, both the surviving spouse and actively employed child are satisfied. The credit shelter trust/QTIP will receive a fixed amount of rent to sustain the surviving spouse's lifestyle and the actively employed child does not have to negotiate the rent with his or her parent and can operate the business knowing the fixed costs.

Employment Contract

If necessary, the business owner may decide to also sign an employment contract during his or her lifetime with the business in order to provide for a source of income to the surviving spouse. Various companies, including public companies, have provided this benefit as a death benefit for their executives.

The Internal Revenue Service challenged these contracts from an estate tax perspective for a number of years on the premise that the commuted value of the payments should be included in the decedent/employee's estate. The IRS had mixed success with this argument[2] until 1981, when the 100% marital deduction became law with the Economic Recovery Tax Act of 1981.[3]

At that point, the IRS switched tactics and argued against deductibility by the business for these payments. In *Ring Power Corp. v. United States*,[4] the district court held that the payments were deductible by the business as long as the agreement provided that (a) the payments were in consideration for past services rendered and (b) the employee/owner was undercompensated in the formative years of the business.

GOAL: MINIMIZE ESTATE TAXES

The second goal of the business owner is to plan in such a way as to minimize estate taxes. The business is obviously an illiquid asset and will consist of a significant portion of the estate. While the Code allows for a deferral of estate taxes over 14 years when certain requirements are met,[5] it would be best to minimize and/or eliminate the estate tax through the use of the annual gift tax exclusion and the lifetime estate and gift tax exemption. Ideally, the business owner would consult with an insurance professional and purchase life insurance to be owned by an irrevocable trust as a source of liquidity to pay the estate taxes.

GOAL: TREAT CHILDREN FAIRLY

The third goal would be for the children to be treated in a fair and equitable manner. Furthermore, the child or children who will continue to run the business must have incentives to do so or else the entire succession plan will fail.

The starting point of discussion is identifying which family member or members will head the organization. Few discussions with estate planning clients are as fraught with emotion as is the decision to choose a leader or leaders for the next generation of a closely held family business. Oftentimes this choice is made by the Darwinian theory of survival of the fittest: whoever has demonstrated ability, sound judgment, leadership, interest and business acumen, among many other traits, while employed in the business will likely win the golden ticket to steward the

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[1] §355. All section references ("§") are to the Internal Revenue Code of 1986, as amended ("the Code"), or the Treasury regulations thereunder, unless otherwise indicated.

[2] *Estate of Schelberg v. Commissioner*, 612 F.2d 25 (2d Cir. 1979); *Estate of Fusz v. Commissioner*, 46 T.C. 214 (1966); Rev. Rul. 92-68, 1992-2 C.B. 257; Rev. Rul. 81-31, 1981-1 C.B. 475.

[3] Pub. L. No. 97-34.

[4] 89-1 USTC ¶9109 (M.D. Fla. Oct. 24, 1988).

[5] §6166.

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family for the foreseeable future. While it is human nature for every family member involved with the company to think that he or she is the most significant contributor to the company's success and that any bad decisions or adverse results are the fault of everyone else, reality says otherwise. In the family business context, for better or worse, this decision is often made by the senior generation owners.

EXAMPLE

There is an S corporation called Vandelay Industries, which was started by the parents, Frank and Estelle, in 1970, and they both died in 2016. They have two children: George, who has worked at the company for 20 years, beginning in sales, and is now a manager; and Lloyd, who, since 1998, has worked at series of startup companies that he hoped would become the next Google and is now an employee at a more stable company.

While they were alive, Frank and Estelle identified George as their choice to succeed them as owners of the company. Vandelay Industries was valued at $12 million on their estate tax returns and comprised 80% of the overall estate valued at $15 million (including a $1 million house and a $2 million IRA). The goal of the estate plan was that each child would receive one-half of the estate, but George would run the company without interference from his brother Lloyd. How can this be accomplished?

The wills should direct that, upon the death of Frank and Estelle, the stock in Vandelay Industries be recapitalized into voting and non-voting stock.[6] (If this were a limited liability company, the will should direct that the LLC be amended to be a manager-managed LLC.) A prudent recapitalization would create 10 shares of voting stock and 90 shares of non-voting stock. The will should further direct that when dividing the estate into 50/50 shares, the 10 shares of voting stock and as many non-voting shares (to equal one-half of the total value of $15 million) shall be allocated to George's 50% share of the estate and the remaining non-voting stock and the house and IRAs be allocated to Lloyd's 50%. In other words, George would receive the 10 voting shares and 52½ non-voting shares worth $7.5 million (or 50% of the $15 million estate) (62.5% × $12 million = $7.5 million) and Lloyd would receive the remaining 37½ shares of non-voting stock worth $4.5 million plus the house and IRAs valued at $3 million, also for a total of $7.5 million.

Both children are being treated equally from an equity perspective, but what would happen if we stopped at this point? Both George and Lloyd would be upset. George would argue that he will continue to grow the business for the next 20 years and when there is some type of liquidity event, Lloyd will have been unjustly enriched by riding George's coattails. On the other hand, Lloyd would argue that the business has never declared a dividend since 1970 and that this stock is like wallpaper and is worthless. The solution would be to incorporate a buy/sell agreement into the will to create a market for the stock and to satisfy both shareholders.

Therefore, the will should further provide that the distribution to George and Lloyd would be contingent on them entering into a shareholders' agreement in which George has the right to buy Lloyd's shares (a "call") and Lloyd would have the right to sell his shares to George (a "put"). George's call can be exercised at any time he decides. If he has sufficient assets to pay for the Lloyd's shares, he can do so immediately or in the future. Conversely, the timing of the exercise of Lloyd's put should be limited to five to 10 years after the death of the survivor as between Frank and Estelle. The reason is that George should be given an opportunity to operate the company without the threat of an immediately large loss of capital. George should have time to get accustomed to operating the business without his parents and to build the working capital account. Since the goal of this planning is the successful transition of control to George, it would be unfair to immediately drain the company coffers of cash for buyout purposes. The thought is that five years should be enough time for George to save money to buy out Lloyd.

Purchase price is always a delicate discussion with closely held businesses, but in this situation, it isn't as controversial. The executor must obtain an appraisal of the business in order to prepare the estate tax return for the parents. Therefore, the will should provide that the purchase price would be calculated using the same methodology as used on the estate tax return and updated as of the date of the exercise of the put or call. In order to avoid running afoul of Chapter 14 of the Code because this is a family transaction, the executor will need a fair market value appraisal anyway. This same appraisal can just be updated with the current financial situation to provide a fair price to George and Lloyd.

Ideally, life insurance should play a significant role in the transaction. George should have purchased a term life insurance policy on the surviving parent (or a survivorship policy on both parents) in order to create an instant influx of cash that can be used by him to buy out Lloyd. If there is no life insurance to pay Lloyd (or only enough for a down payment), George will give Lloyd a promissory note. The terms of the note should be spelled out in the will. There would be interest at the greater of the applicable federal rate or the prime rate and the note would be self-amortized over five, 10 or 15 years, depending on Lloyd's need to be paid and George's ability to meet that demand based on cash flow. Practically speaking, the note should not be paid over more than 15 years because both parties would like to put the transaction behind them. Also, the IRS will treat a note lasting more than 15 years as equity and not debt, which will cause certain unintended tax consequences.[7]

The shareholders' agreement would also include a recapture clause as well as a tag along clause. A re-

[6] Reg. §1.1361-1(l)(1).

[7] Rev. Proc. 2017-3, 2017-1 I.R.B. 130.

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capture clause is meant to create fairness between the parties in case the business is later sold for a higher price. An example of this would be if George bought out Lloyd for $4.5 million in 2017 and in 2018, he then sold Vandelay Industries to Kramerica Industries for $15 million. In a situation where the company is sold within two to three years after it was purchased, it is highly likely that this increase in purchase price is more luck and timing than business acumen. Because the price George sold for was a theoretical fair market value, it is only fair that Lloyd share in this increase. The recapture clause provides that the seller will receive his pro-rata share of the increased sales price, or, in other words, Lloyd would receive $1,125 million of the $15 million sales price (37.5% of the extra $3 million value [$15 million – 12 million]).

On the other hand, if neither party has exercised his put or call and continues to own the stock and a third party is interested in buying the business, a tag along clause is necessary to ensure that the minority stockholder cannot stymie the sale of the company. As previously mentioned, George will own all 10 shares of voting stock and 52½ shares of non-voting stock with Lloyd owning the 37½ shares of non-voting stock. While George may decide to sell his voting stock to Kramerica Industries, it is unlikely that the buyer will be satisfied with owning less than 100% of the stock of a closely held business. Therefore, the stockholders' agreement should have a clause mandating that if the owner of the voting stock wants to sell his shares, all of the remaining stockholders must sell his or her shares to the same buyer as well.

CONCLUSION

As is evident from this article, there are many contingencies to consider when developing a business succession plan. Each party at each generational level has his or her own opinion and needs that must be considered in the design. Also, the solutions cannot be arrived at in a vacuum by just the client and attorney. All estate plans, especially those involving succession planning, are a team effort among the attorney, accountant, financial advisor and trust company. Because succession planning involves knowledge of the tax law, corporate law and trusts and estates law, each advisor's input is critical to ensure a smooth transition of management and ownership.

Once the clients and advisors are satisfied with the plan, it is important that the family meet (including the sons-in-laws and daughters-in-laws) so that the parents can present the results and everyone can air their pleasure or objections. It is preferable to have the children (and their spouses, who occasionally wield the power) understand the decisions made by the parents while they are both alive and able to articulate their thoughts instead of having a plan thrust upon them by the executor without any knowledge of the background of the succession plan. The intent is that this will hopefully avoid any fights between or among the children and allow the business to flourish under the capable leadership of the child (or children) who have been chosen to lead the next generation.

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