Overlooked Techniques for Passing on the Family Business: Passing the Family Business on to the Next Generation When Some of the Children Will Not Be Active but Treating All Children Equally

by

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I. Introduction

This outline[1] presents various techniques to be considered when passing a family business on to the next generation, particularly when there are family members both who are active in the business and those who are not. Traditional techniques are typically designed to shelter the closely-held business from inclusion in the gross estate or involve arrangements that allow the active and inactive family members to go their separate ways, such as by redeeming the interests of the inactive family members. Such methods often fail to properly address common obstacles that exist in intergenerational family businesses, such as financial inequality and conflict among members of successive generations. As discussed in this outline, there are other techniques that may better accomplish each of the family's business and long-term estate planning objectives. The discussion is generally non-technical, though tax provisions are cited where relevant.

Note that even in a scenario where gift and estate taxes are not a concern (*e.g*. the family business is growing outside of the senior generation's estate or there is enough estate tax exemptions), the techniques in this outline remain relevant, as succession planning is also concerned with income tax planning and non-tax concerns, including the personal and financial goals for successive generations.

II. The Typical Situation and Its Challenges

The best way to understand business succession planning is through simple illustrative examples. Accordingly, the facts described immediately in II.a below will be used as a foundation to illustrate the various techniques discussed throughout this outline.

a. Overview of Facts

Patriarch is the sole owner of **Family Business**. For state law purposes, Family Business is organized as a single-member limited liability company known as **Family Business LLC**. In accordance with Treas. Reg. § 301.7701-3(b)(1)(ii), Family Business LLC is a disregarded entity for Federal tax purposes and is a treated as a sole proprietorship.

The fair market value of Family Business as an ongoing concern is currently $12,000,000. The Family Business's net earnings are usually approximately $800,000 a year (for a return of 6.67% a year). Patriarch has only $4,000,000 of other assets.

Patriarch has four **Children**: **Daughter** and three **Sons**. Defying traditional gender stereotypes, Daughter actively participates in Family Business, while the three Sons do not wish to take an active role and do not wish to be exposed to the risks and vicissitudes often associated with a family business. Daughter wishes to expand Family Business and to reinvest earnings in the business to grow the business.

[1] This paper was previously presented at the 44th Annual Notre Dame Tax & Estate Planning Institute on October 12, 2018 and is reproduced with the permission of the Notre Dame Law School.

Patriarch desires to treat the Children equitably; that is, he would like his children to inherit approximately equal shares of Patriarch's wealth, *i.e.,* \$3,000,000 each from Family Business; or \$4,000,000 each from total assets owned by Patriarch.

	Family Business	**Other Assets**	**Total Wealth**
Value:	\$12,000,000	\$4,000,000	\$16,000,000
Child's Share:	\$3,000,000	\$1,000,000	\$4,000,000

b. Practical Challenges

In devising a business succession plan, Patriarch faces a number of practical challenges. These challenges include the following:

1. Conflicting wishes of Children

   Daughter wants to stay in the business and reinvest earnings. Sons, by contrast, would prefer to receive cash to reinvest as they see fit without being locked into an investment that they are not involved.

2. Insufficient other assets to satisfy all Children's wishes

   If Patriarch had \$36,000,000 of other assets, the Children's wishes (putting aside estate tax issues) would be easy to satisfy: Patriarch could give \$12,000,000 cash to each of the Sons and the \$12,000,000 Family Business to Daughter. Unfortunately, Patriarch only has \$4,000,000 apart from Family Business to divide among Children.

3. Potential for conflict between Children

   If Daughter, the active child, receives the entire ownership of the business, it may create tension with other Children when the business grows. Alternatively, if the Sons receive preferred interests and Daughter receives common, and the business does not generate sufficient earnings to pay out to the common interest, Daughter may feel that all of her efforts to grow the business are benefiting the inactive Children. Finally, if the business is very successful, there may be conflict due to the inequality of profit received by the inactive Children when the business is sold.

c. Traditional Solutions

1. Borrow to buy out inactive owners

One solution would be for Family Business LLC to borrow $8,000,000 from a commercial lender in order to pay out $2,666,667 to each of the Sons. The $2,666,667, plus a one-third share of the Patriarch's other assets (i.e., $4,000,000 ÷ 3 = $1,333,333), would give each Son $4,000,000. Daughter would then have the $12,000,000 Family Business, encumbered by an $8,000,000 debt, for a net to Daughter of $4,000,000.

	Business	**Loan Proceeds**	**Other Assets**	**Total**	**Per Child**
Sons (Inactive)	$0	$8,000,000	$4,000,000	$12,000,000	*$4,000,000*
Daughter (Active)	$4,000,000 [$12,000,000 less $8,000,000 debt]	$0	$0	$4,000,000	*$4,000,000*

Although Children are apparently treated equally in this manner, Patriarch may not wish to use debt. For one thing, the interest expense on the $8,000,000 debt reduces the net earnings Daughter would like to continue to invest in Family Business. Moreover, Sons each get $4,000,000 outright, whereas Daughter bears all the risk of a downturn in Family Business's fortunes. (On the other hand, she does retain all the upside.) Family Business also has increased risk of insolvency because of the financial leverage. And, the commercial loan must pay interest and principal even if the business does not generate enough cash to pay its obligations in a timely manner as they become due. For these reasons, Patriarch may not see commercial debt as an attractive solution.

2. Buy out inactive owners with future earnings

Another solution is to have Sons bought out in exchange for a deferred purchase price. For example, Patriarch could bequeath an equal share of Family Business LLC to each Child. For tax purposes, once Patriarch's estate transfers membership interests in Family Business LLC to the Children, Family Business LLC automatically converts to a partnership for Federal income tax purposes.[2] Each new partner that receives an interest in the LLC will be treated as receiving a proportionate share of the LLCs assets, and immediately thereafter, each new partner will be treated as contributing those assets to a partnership in exchange for ownership interests in the partnership.[3] Under § 721(a), no gain or loss is recognized by the partners.

[2] Treas. Reg. § 301.7701-3(f)(2).

[3] Rev. Rul. 99-5.

Family Business LLC would then redeem each of Son's one-quarter membership interest for a $3,000,000 promissory note. Under § 736(b), installment payments under the note would generally be treated as distributions from Family Business LLC. Consequently, in contrast to the usual installment method rules under § 453, basis is recovered first pursuant to § 731(a)(1). Family Business LLC would then use its earnings to make installment payments under the notes.

Patriarch may prefer this solution to commercial borrowing to redeem Sons because Children would share in the risk of Family Business being unable to meet its obligations to pay the promissory notes. There is also no third-party borrowing that creates a risk of insolvency. On the other hand, Daughter's goal to keep reinvesting earnings in the Family Business is frustrated.

3. Life insurance

A third strategy is to acquire insurance on the life of Patriarch, which can be used to provide an inheritance to Sons in lieu of interests in Family Business. There are a variety of ways in which the acquisition of life insurance could be structured. Getting the financially equitable results is more difficult than it may appear.

i Active Child acquires insurance to buy out inactive Children

Daughter could buy $9,000,000 of life insurance on Patriarch's life, which she could use after Patriarch's death to buy out Son's shares of Family Business.

A difficulty with this strategy is that Daughter must pay for the life insurance. That result is inequitable, as Daughter will experience financial pressure during her lifetime. Patriarch could instead make gifts to Daughter (or a trust for her benefit) in order to finance the life insurance, but that just reverses the inequity: the gifts will permit Daughter to be able to receive a $12,000,000 business, while each Son receives less.

To achieve financial parity, Patriarch could make loans to Daughter (or a trust for her benefit) in order to finance the acquisition of life insurance. Daughter (or the trust) would then be required to repay Patriarch's estate. As with redeeming Sons for promissory notes, however, Daughter would either have to use Family Business earnings in order to finance the buy-out, or repayment would come out of the life insurance, which leave less funds available to buy out Sons.

ii Gift of business to active Child with life insurance to compensate inactive Children

Alternatively, Patriarch, through a combination of gifts and sales, could transfer Family Business LLC to an irrevocable grantor trust for descendants (referred to herein as a "**Dynasty Trust**"). Dynasty Trust could then buy life insurance policy on Patriarch's life to compensate non-active Children who do not receive interests in Family Business.

Note, however, that in order to treat Children equally, a large amount of life insurance would need to be acquired. Specifically, only if Dynasty Trust acquires

$36,000,000 of insurance would each Child be able to receive an equal share, *i.e.,* $12,000,000 cash for each Son and a $12,000,000 Family Business for Daughter. It is unlikely that that amount of insurance could be acquired as a practical matter, both because of capacity limitations and the non-deductible expense of the insurance premiums.

iii Life insurance as tax-efficient savings plan

Life insurance, particularly if a universal policy is acquired, often acts as a mechanism, like a Roth IRA, for setting aside funds now to provide liquidity later. So long as the contract meets the definition of life insurance under § 7702(a), cash value builds up tax-free.[4] In addition, proceeds paid at death are received tax free under Section 101(a), thereby eliminating inherent gain at death.

Because of these income tax benefits, life insurance can be a good vehicle for setting aside earnings of Family Business and permitting them to grow tax-free, and then ultimately used to provide a benefit to family members who are not active in Family Business in lieu of interests in Family Business.

From Patriarch's perspective, a downside of using life insurance in this way is that earnings from Family Business must be set aside to buy the life insurance. And, the cost of the premiums is not deductible for income tax purposes. Patriarch may prefer to reinvest earnings in Family Business.

d. Problems Created by Standard Estate Tax Planning Techniques

Suppose Patriarch was advised to reduce potential estate taxes by transferring interests in Family Business LLC to a Dynasty Trust, through a combination of gifts and sales (including installment sales and via GRATs). Now there is an additional problem: as the Dynasty Trust passes outside of Patriarch's estate for estate tax purposes, interests in Family Business LLC will not qualify for a step-up in basis at death.[5] As a result of successful estate tax planning, buying out the Sons' interests will trigger a larger capital gain than if Patriarch had simply retained the interests in Family Business LLC.

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[4] *Cf.* § 7702(g) treating the increase in value of a policy immediately reportable as ordinary income if the policy fails to meet the definition of life insurance.

[5] *See generally* Bramwell and Vara, "Basis of Grantor Trust Assets at Death: What Treasury Should Do?" *Tax Notes*, August 6, 2018.

III. The Preferred Partnership

A preferred partnership can achieve more satisfactory results than other techniques, at least where there are active and inactive family members.

A preferred partnership is a partnership (or LLC), characterized as a partnership for Federal income tax purposes, with two classes of partnership interests – preferred and common. The "preferred" partners are entitled to a fixed cumulative return preference (*e.g.* annual distribution of fixed guaranteed payment or a priority allocation of income), whereas the "common" partner will receive a periodic distribution only to the extent that the partnership generates net earnings in excess of the preferred distributions. Accordingly, the value of the preferred interest is "frozen" at the fixed interest, and any growth inures solely to the common partner.

a. Example of Preferred Partnership Technique

Suppose Patriarch causes Family Business LLC's capital structure to be revised as follows:

Capital account balances. Since Patriarch wants to treat Children equally, each Child will receive an equal $3,000,000 share of the Family Business LLC, valued at $12,000,000. This will be effectuated by giving each Child a membership interest with an associated capital account balance of $3,000,000.

A "capital account" is essentially what an owner would be entitled to receive upon liquidation of the entity. A detailed discussion of capital accounts is beyond the scope of this outline.[6]

Preferred interest to inactive Children. Each Son has a right to a priority return of an annual amount equal to 6.67% of the $3,000,000 value for his capital account. More particularly, net earnings of Family Business LLC must first be allocated to the Sons and added to Sons' capital accounts to satisfy their rights to the priority preferred allocation of income. If partnership income is insufficient to satisfy the preferred priority return in a given year, the shortfall is tracked in arrearage accounts, and is required to be made up in future years.

Distributions to inactive preferred partners. Every year, Family Business LLC distributes the Sons' preferred shares of earnings to them. The distributions could be made either in the discretion of management or as required by the terms of Family Business LLC's governing documents.

Salary and balance of earnings to active Child. Daughter is entitled to a reasonable salary, which is treated as a "guaranteed payment" under § 707(c) and is a business expense deduction to Family Business LLC. Her capital account is credited with all earnings after the preferred allocations of partnership income are satisfied. Family

[6] The concept of capital accounts in the context of partnership allocations is spelled out in Treas. Reg. § 1.704-1(b)(2).

Business LLC makes distributions to Daughter to cover her tax liabilities, but otherwise reinvests Daughter's share of earnings.

How to implement. We discuss later in this outline when the preferred capital structure should be implemented, including the implications under § 2701. For now, assume Patriarch, either during lifetime or at death, has passed all of the membership interests in Family Business LLC to his four Children.

1. Results if earnings remain constant at $800,000

Let's suppose that in the first couple of years, Family Business LLC continues have net earnings of $800,000 a year. (Included in the expenses charged against earnings is Daughter's salary.) Remember that each Son has a priority right to a 6.67% return on his capital account. Each Son's capital account is $3,000,000. Thus, each Son's capital account is credited annually with $3,000,000 x 6.67% = $200,000. Family Business LLC then distributes each Son's $200,000 share of net earnings to him, and Son's capital account is reduced by the same amount. Thus, at the end of the year, each Son's capital account always ends up at $3,000,000, which is equal to the $3,000,000 he started with, plus his $200,000 share of earnings, less his $200,000 distribution.

Daughter's capital account is credited with the balance of Family Business LLC's net earnings. Thus, her capital account is credited with $200,000, which is equal to $800,000 of net earnings less the $600,000 credited to Sons. Let's say that Family Business LLC distributes $80,000 to her in order to cover her tax liabilities. That amount reduces Daughter's capital account, leaving her a net addition to her capital account for the year of $120,000, i.e., her $200,000 share of earnings less her $80,000 tax distribution.

Year	Net Earnings	Total Preferred Allocation 6.67%	Common allocation	Arrearage	Income Tax on Common Profits	After Tax Retained Earnings
1	$800,000	$600,000	$200,000	0	$80,000	$120,000
2	$800,000	$600,000	$200,000	0	$80,000	$120,000

i Evaluating the results

The results above are not bad from the family's perspective. Sons earn 6.67% on their investment, which is a good fixed-income return in today's economic environment. Daughter earns salary and gets to reinvest $120,000 of earnings each year back into the business.

Looking ahead, if the business's earnings drop, Sons are protected against downside by their priority allocations, while Daughter bears the brunt of the risk. If business earnings increase, Daughter receives the upside, while Sons' returns are capped at 6.67%. These results are fair, as Daughter is the one doing the work and putting her own share of earnings at risk.

2. Results if earnings fall but are sufficient to satisfy return preferences

Now let's suppose that in year 3, Family Business LLC's net earnings fall to $600,000. Each Son has a priority right to a 6.67% return on his capital account. As explained above, each Son therefore receives a distribution of $200,000. That exhausts the Family Business's entire net earnings for the year, and Daughter is not allocated any of the partnership's $600,000 of income.

i Evaluating the results

Once again, the results above are not bad from the family's perspective. Sons continue to earn 6.67% on their investment. Moreover, as this variation shows, Sons did not suffer from the downturn in earnings; they still receive their $200,000 in distributions. Daughter still earns salary but the disappointing results for the year mean that she cannot reinvest any earnings back into the business. Rather, all the earnings get paid out to Sons.

Year	Net Earnings	Total Preferred Allocation 6.67%	Common allocation	Arrearage	Income Tax on Common Profits	After Tax Retained Earnings
1	$800,000	$600,000	$200,000	0	$80,000	$120,000
2	$800,000	$600,000	$200,000	0	$80,000	$120,000
3	**$600,000**	**$600,000**	**$0**	**$0**	**$0**	**$0**

3. Results if earnings fall and are insufficient to satisfy return preferences

Now let's suppose that in year 4 Family Business LLC's net earnings fall to $500,000. Each Son has a priority right to a 6.67% return on his capital account, which amounts to $200,000, or $600,000 total for the three Sons. Net earnings, however, are insufficient to pay out the full $200,000 to each Son. Each Son receives only $166,667 each, which exhausts the Family Business's entire net earnings for the year. Daughter's capital account receives nothing.

From the Sons' perspective, all is not lost. Although their respective distributions for the year fell $33,333 short of their preferred return, the Family Business LLC records that shortfall in an arrearage account. If earnings later rebound, Sons will be entitled to the earnings up their arrearage accounts before net earnings are credited to Daughter's capital account.

Year	Net Earnings	Total Preferred Allocation 6.67%	Common allocation	Arrearage	Income Tax on Common Profits	After Tax Retained Earnings
1	$800,000	$600,000	$200,000	0	$80,000	$120,000
2	$800,000	$600,000	$200,000	0	$80,000	$120,000
3	$600,000	$600,000	$0	$0	$0	$0
4	**$500,000**	**$500,000**	**$0**	**$100,000**	**$0**	**$0**

i Evaluating the results

Although the downturn in earnings is disappointing, the economics still make sense for the family. In terms of cash, each Son receives a return on his investment of 5.56%. That is less than their 6.67% preferred return. However, the shortfall is converted into an asset, namely, an arrearage account that must be paid out before net earnings are allocated to Daughter.

Daughter still earns salary but the disappointing results for the year mean that she cannot reinvest any earnings back into the business. Rather, all the earnings get paid out to Sons, who will also have an additional priority in future years for the shortfall equal to their arrearage accounts.

4. Results if earnings rebound sufficiently to pay out arrearage accounts

In year 5, net earnings rebound to $800,000. Each Son has a priority right, first, to a 6.67% return on his capital account, which amounts to $200,000, or $600,000 total for the three Sons. That leaves $200,000 of net earnings.

In addition, each Son also has a right to have his arrearage account satisfied with remaining net earnings. Thanks to the earlier year's disappointing net earnings of $500,000, each Son has an arrearage account of $33,000. Thus, in addition to $200,000, each Son must be allocated $33,000 and their capital accounts must also be credited with $33,000. As Family Business LLC distributes each Son's share of net earnings every year, each Son's capital account is then reduced by the $233,000 distribution. Thus, each Son's capital account (as always) ends up at $3,000,000.

Daughter's capital account is allocated only $100,000 of partnership income and her capital account is credited with the balance of Family Business LLC's net earnings. Thus, her capital account is credited with $100,000, which is equal to $800,000 of net earnings less the $700,000 credited to Sons. Let's say that Family Business LLC distributes $40,000 to cover Daughter's income tax liabilities. That amount reduces Daughter's capital account, leaving her capital account with an additional balance of $60,000, *i.e.,* her $100,000 share of earnings less her $40,000 tax distribution.

Year	Net Earnings	Total Preferred Allocation 6.67%	Common allocation	Arrearage	Income Tax on Common Profits	After Tax Retained Earnings
1	$800,000	$600,000	$200,000	0	$80,000	$120,000
2	$800,000	$600,000	$200,000	0	$80,000	$120,000
3	$600,000	$600,000	$0	$0	$0	$0
4	$500,000	$500,000	$0	$100,000	$0	$0
5	**$800,000**	**$700,000**	**$100,000**	**$0**	**$40,000**	**$60,000**

i Evaluating the results

Once again, the results above are not bad from the family's perspective. For the year, each Son receives a return on investment of 7.78%, which makes up for the disappointing 5.56% cash return earned in the prior year. Daughter earns salary and gets to reinvest $60,000 of earnings back into the business.

5. Results if earnings exceed expectations

Finally, let's suppose that in year 6, net earnings do better than they did historically and increase to $1,200,000 a year. Each Son has a priority right, first, to a 6.67% return on his capital account, which amounts to $200,000, or $600,000 total for the three Sons. That leaves $600,000 of net earnings, all of which is allocated to Daughter and added to her capital account. Let's say that Family Business LLC distributes $240,000 to Daughter to cover her tax liabilities. The distribution reduces Daughter's capital account, leaving her capital account with an addition for the year of $360,000*, i.e.,* her $600,000 share of earnings less her $240,000 tax distribution.

Year	Net Earnings	Total Preferred Allocation 6.67%	Common allocation	Arrearage	Income Tax on Common Profits	After Tax Retained Earnings
1	$800,000	$600,000	$200,000	0	$80,000	$120,000
2	$800,000	$600,000	$200,000	0	$80,000	$120,000
3	$600,000	$600,000	$0	$0	$0	$0
4	$500,000	$500,000	$0	$100,000	$0	$0
5	$800,000	$700,000	$100,000	$0	$40,000	$60,000
6	**$1,200,000**	**$600,000**	**$600,000**	**$0**	**$240,000**	**$340,000**

i Evaluating the results

Once again, the results above are not bad from the family's perspective. Sons earn 6.67% on their investment, which is a good fixed-income return in today's economic environment. Daughter earns a salary and gets to reinvest $340,000 of earnings each year back into the business.

Note that Daughter is getting wealthier at a faster rate than the Sons. Her capital account is now growing by $340,000 a year. If net earnings do not fall and she continues to reinvest her earnings in the business, after 18 years, her capital account will be at least $9,360,000, i.e., the $3,000,000 that she started with, plus $300,000 retained earnings from the first 3 years and the $6,120,000 of retained earnings added to capital in the high earning years. She will own more than half the business, while Sons will each have a capital account effectively frozen at $3,000,000. (They also will each have received a total of $4,600,000 of distributions; Daughter will have received a total of $4,520,000 in distributions to pay taxes.) If Family Business LLC is sold, most of the reward will go to Daughter. ***See Schedule 1 for further illustration.***

b. Dealing with Returns Exceeding Expectations

As described just above, it is possible that Family Business will outperform expectations, and thereby cause Daughter to reap an outsize portion of the rewards.

1. Buying out inactive partners

Sons, seeing that earnings are being reinvested in Family Business, may wish earnings instead to be used to redeem their interests. Daughter, rather than reinvest, can instead have Family Business start redeeming Sons' $3,000,000 capital accounts. Eventually, Daughter can buy out Sons entirely. Sons, to the extent they have capital invested in Family Business, will still earn a 6.67% annual return, and get to reinvest their redeemed capital elsewhere, or spend it.

2. Selling for a premium

Suppose that, as a result of strong earnings, Daughter's capital account is $9,000,000, while Sons' respective capital accounts remain fixed at $3,000,000 each. Daughter then sells the business for $26,000,000. After payment of capital accounts, but prior to the allocation of sale proceeds, Daughter will receive at least $9,000,000, and each Son will receive at least $3,000,000.

What about the $8,000,000 balance of the sale proceeds? Rather than have it allocated entirely to Daughter's common interest, Patriarch can provide in Family Business LLC's organizing documents that the windfall –i.e., the amount paid for Family Business in excess of the capital invested – is divided between the partners. For example, each partner could receive an equal share of the $8,000,000 windfall, or the common partner (Daughter) could receive most of the premium (for example, one-half, or $4,000,000) while the preferred partners receive the balance.

c. Greater Equality Between Children

Let's say that Patriarch wants more equal treatment between the inactive and active children, so that that Children share equally in both the risks and benefits of Family Business LLC. Patriarch reorganizes the capital structure of Family Business LLC, retaining a $12,000,000 preferred interest and an 80% non-voting common interest.[7] All

[7] The 80% and 20% common interests have a zero capital account to start with, and are entitled to a share of partnership profits only after the preferred priority allocation of profits have been sasisfied.

four children receive equal shares of the preferred interest (25% each) and the common non-voting interest (20% for each of the four children). Daughter becomes a partner and receives a 20% common interest that is also the sole voting interest. Assume that Family Business LLCs net earnings are as illustrated in II.a., above.

Year	**Net Earnings**	**Preferred 6.67%**	**Preferred Arrearage**	**20% Common share**	**80% common share**	**Daughter's Total Earnings**	**Each Son's Total Earnings**
1	$800,000	$800,000	$0	$0	$0	$200,000	$200,000
2	$800,000	$800,000	$0	$0	$0	$200,000	$200,000
3	$600,000	$600,000	$200,000	$0	$0	$150,000	$150,000
4	$500,000	$500,000	$500,000	$0	$0	$125,000	$125,000
5	$800,000	$800,000	$500,000	$0	$0	$200,000	$200,000
6	$1,200,000	$1,200,000	$100,000	$0	$0	$300,000	$300,000
7	$1,200,000	$900,000	$0	$60,000	$240,000	$345,000	$285,000
8	$1,200,000	$800,000	$0	$80,000	$320,000	$360,000	$280,000
Total	**$7,100,000**	**$6,400,000**	**$0**	**$140,000**	**$560,000**	**$1,880,000**	**$5,220,000**

In the first 2 years, Family Business LLC's net earnings continue to generate a constant $800,000, and each child is allocated $200,000, the same as under the standard preferred partnership in II.a.1. However, in years 3 and 4, when Family Business LLC's net earnings fall, all Children share in the earnings, and bear the risk of shortage in that year equally (rather than Daughter bearing the entire risk).

In years 5 and 6, the preferred interests are paid in full, and the arrearage accounts are paid with the balance of net earnings. In each such year, Children each receive equal allocations of Family Business LLC's net earnings (the 6.67% priority return of $200,000 each, as well as $100,000 each due from the arrearage account in year 6). As Family Business LLCs earnings begin to increase, Children share equally.

In year 7, there are earnings in excess of the arrearage account. Children are each allocated their $200,000 preferred share, $25,000 from the arrearage account, and $60,000 from the non-voting common share. Daughter will have an additional earnings allocation of $60,000 from her 20% voting common interest. Accordingly, each Son receives earnings of $285,000, while Daughter receives earnings of $240,000. To the extent that such earnings are reinvested in the business, the respective capital account will increase. In each subsequent year, if Family Business LLC's continues to generate net earnings of $1,200,000, Sons will each receive a total allocation of $280,000, and Daughter will receive a total allocation of $360,000.

Similar to the standard preferred partnership, the higher the net earnings generated in any given year, the greater the disparity between the allocations to Sons and Daughter. However, all Children will share in the risks and benefits of Family Business LLC's performance. When Family Business LLC does well, Sons will share in those earnings, and when it underperforms, they will share in the loss in that year. Such an arrangement may better meet Patriarchs objectives in providing for equal treatment to Children. Further, it may reduce friction between Children as providing greater fairness. Children will receive equal interests in Family Business LLC, except that Daughter will receive an annual salary and the 20% voting common interest in exchange for her performance of services.

d. Implementing with an S Corporation

An S corporation is not permitted to have different classes of stock.[8] Thus, it is not possible to reorganize an S corporation in order to create preferred interests.

1. Basic solution: S corporation becomes preferred partner

To get around S corporation restrictions, Patriarch could give S corporation shares to Children, and have the S corporation contribute Family Business to a partnership with active family member (Daughter). S corporation would receive preferred interests, while Daughter would receive common interests.

2. Carried interest variation

Daughter can acquire partnership interests in exchange for the performance of future services, compensated by a guaranteed payment and an interest in future profits. For example, following the common arrangement in private equity funds, Daughter could be entitled to 20% of future profits after the S corporation's preferred return is satisfied. Note that Daughter can receive both a share of the S corporation, and, therefore, an indirect interest in the preferred interests, as well as the 20% profits interest.

e. Practical Implementation Issues

1. Daughter's salary

Daughter will always need some salary (*i.e.,* a guaranteed payment) in order to keep working for the business and having money at least to live on. Daughter, therefore, will rights to distributions that have priority over Sons' preferred returns.

i Friction over size of guaranteed payments

The appropriate size of the guaranteed payment can often be a source of friction between the active insiders (who typically feel undercompensated and underappreciated) and inactive passive investors (who typically feel that they are overpaying for family members' services).

ii No friction if earnings are sufficient

In principle, there is no source of conflict so long as earnings are sufficient to pay out the priority return in full, without a build-up of arrearage accounts. After all,

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8 § 1361(b)(1)(D).

the inactive preferred partners receive the maximum that they are entitled to, regardless of how the active partners are compensated.

2. Financial statements

The preferred partnership will only work as a practical matter if all investors have confidence in the partnership's financial accounting. Audited financial statements prepared by an independent CPA are advisable.

3. Explaining the plan

It is usually advisable to explain the plan to the next generation so that they can understand and agree to it in advance.

f. Timing of Implementation

1. Considerations if preferred partnership is implemented during lifetime

Patriarch could implement the preferred partnership during his lifetime. In the simplest case, he could transfer all his membership interests in Family Business LLC to Children during his lifetime.

i Effect on entity classification

Gifts of interests in the (formerly) single-member, disregarded entity to new partners will cause Family Business LLC to convert to a partnership for Federal income tax purposes.[9] Each new partner that receives an interest in the LLC will be treated as receiving a proportionate share of the LLCs assets, and immediately thereafter, each new partner will be treated as contributing those assets to a partnership in exchange for ownership interests in the partnership.[10]

If the gifts are made to grantor trusts, however, Family Business LLC will continue to be treated as a disregarded entity.[11]

ii Gifts respected for income tax purposes

Consideration should be given to whether § 761(b), the second sentence of which was formerly contained in § 704(e), will prevent gifts of membership interests in Family Business LLC from being respected for income tax purposes, so that future allocations are not treated as retained by the donor. Among other requirements, capital must be a material income-producing factor.[12] Section 761(b) essentially

9 Treas. Reg. § 301.7701-3(f)(2).

10 Rev. Rul. 99-5. Under § 721(a), no gain or loss is recognized by the new partners.

11 See PLR 2001-02-037.

12 Treas. Reg. § 1.704-1(e).

codifies and provides guidelines for the application of assignment-of-income concepts articulated in the foundational cases of *Lucas v. Earl*, 281 U.S. 111 (1930) and *Helvering v. Horst*, 311 U.S. 112 ((1940).

Suppose that Patriarch instead makes gifts of membership interests to irrevocable grantor trusts. In that case, § 671 and the grantor trust rules will cause the income, deductions, and credits of Family Business LLC to be attributed to Patriarch regardless of whether the requirements of § 761(b) are satisfied. But then there is gift tax issue: if the income from Family Business is attributed to Patriarch under assignment-of-income principles rather than under the grantor trust rules, then arguably Patriarch should, by analogy, also be treated for gift tax purposes as receiving and transferring the income of Family Business LLC to the grantor trusts.

iii Step up in basis

Irrevocable gifts during lifetime, if not pulled back into the gross estate, will cause a loss of the step up in basis at death.

iv Minority interest discounts

Gifts during lifetime can reduce gift and estate taxes to the extent that they generate valuation discounts. If Patriarch dies holding 100% of the membership interests in Family Business LLC, no valuation discounts will be available at death. By contrast, gifts of membership interests in Family Business LLC to each of the four Children may each qualify for valuation discounts for lack of marketability or lack of control. Separate gifts of interests in the same property are not aggregated for gift tax purposes.[13]

v Section 2701

In general, § 2701 can artificially trigger a taxable gift, or artificially increase the value of any gift of an interest in a partnership (or a corporation) transferred to or for the benefit of a member of the transferor's family (such as a child), if the transferor or an "applicable family member" (such as a spouse or an ancestor) retains either certain distribution rights in a controlled entity or a liquidation, put, call, or conversion right. Although a detailed discussion of Section 2701 is beyond the scope of this outline, below are some considerations.

A. No Section 2701 implications if Patriarch does not retain an interest

If Patriarch gives away all of his interests in Family Business LLC to Children, there is no need to be concerned about Section 2701 artificially increasing the amount of the taxable gift, as neither the transferor (*i.e.,* Patriarch) nor any applicable family member (*i.e.,* a spouse, an ancestor, a spouse's ancestor, or a spouse of an ancestor or a spouse's ancestor) retains an interest in Family Business LLC.

13 Rev. Rul. 93-12.

If there is an applicable family member, such as a spouse, who holds an interest immediately after the transfer, Section 2701 could still apply.

B. Section 2701 does not apply if Patriarch retains a common interest

If Patriarch makes gifts of preferred interests and only retains the common interest, Section 2701 will not apply, as the common interest does not confer a distribution right for Section 2701 purposes.[14]

C. Section 2701 does not apply if Patriarch retains a right to guaranteed payment

If Patriarch makes gifts of membership interests and retains a right to a guaranteed payment described in Section 707(c) of a fixed amount (such as right to a fixed salary), Section 2701 will not apply, as a guaranteed payment of a fixed amount is not considered a distribution right.[15]

D. No Section 2701 artificial valuation increase if Patriarch retains a right to a "qualified payment"

If Patriarch makes gifts of membership interests and retains cumulative preferred rights payable periodically, on a cumulative basis, and on the basis of a fixed rate, Section 2701 will not artificially increase the value of the gift.[16] A right of this kind is known as a "qualified payment" right and is similar to the Sons' preferred interests. Thus, Patriarch could retain a preferred interest of this kind without triggering adverse consequences under Section 2701. Patriarch may also elect to treat any retained interest as a qualified payment.[17]

Note that a qualified payment right may be a way to provide an income stream to Patriarch during his retirement.

E. Caution in case preferred interests are held in trust

If preferred interests are held in trust, caution should be exercised to ensure that Section 2701 is not inadvertently triggered. Interests held in trust are treated for purposes of Section 2701 as if they held indirectly by the beneficiaries.[18] If an applicable family member (such as a spouse) is a beneficiary, therefore, and a transfer of membership interests is made to a member of the transferor's family, Section 2701 could apply.

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14 § 2701(c)(1)(B)(ii).

15 § 2701(c)(1)(B)(iii).

16 § 2701(a)(3)(A) and § 2701(c)(3)(A).

17 § 2701(c)(3)(C).

18 § 2701(e)(3).

2. Considerations if preferred partnership is implemented at death

Patriarch could also implement the preferred partnership at death. In the simplest case, he could bequeath preferred interests to Sons and the common interest to Daughter.

i Step up in basis

By retaining interests in Family Business LLC until his death, Patriarch causes the LLC interests to be stepped up to their fair market value (including going concern value) at death under Section 1014(a).

ii Effect on entity classification

For tax purposes, once Patriarch's estate transfers membership interests in Family Business LLC to the Children, Family Business LLC would convert to a partnership for Federal income tax purposes.[19] Each new partner that receives an interest in the LLC will be treated as receiving a proportionate share of the LLCs assets, and immediately thereafter, each new partner will be treated as contributing those assets to a partnership in exchange for ownership interests in the partnership.[20] Under § 721(a), no gain or loss is recognized by the new partners.

iii Gifts respected for income tax purposes

Even if capital is not a material income-producing factor – for example, Family Business is a service business – the Children's inherited interests should still be respected.

iv Minority interest discounts

If Patriarch retains all interests until death, there will no estate tax valuation discounts at death for lack of control or marketability.

v No Section 2701 estate tax consequences

Section 2701 applies only for purposes of determining whether a transfer of an interest is a gift and the value of the gift. Thus, it does not have an effect on the estate tax value of what is included in Patriarch's gross estate.

In fact, it may be possible to avoid Section 2701 through bequests made at death. For example, Patriarch could bequeath non-2701-compliant preferred interests to a surviving spouse and the common interests to descendants. The spouse would not be considered to hold the common interests in that case.[21]

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19 Treas. Reg. § 301.7701-3(f)(2).

20 Rev. Rul. 99-5.

21 Treas. Reg. § 25.2701-6(a)(4).

IV. Private Annuity Sales: An Underutilized Technique

a. Private Annuity Overview

In a private annuity sale, Patriarch would sell his interest in Family Business LLC to Dynasty Trust in exchange for a right to a fixed stream of payments for his life. Typical considerations in a private annuity sale are as follows:

1. No gross estate inclusion

   A properly structured private annuity is not included in the grantor's gross estate under Section 2036(a)(1), as the right to the annuity is an obligation of the payor rather than a retained right described in Section 2036(a)(1).[22]

2. No gain recognition

   Because the Dynasty Trust is a grantor trust with respect to Patriarch, the private annuity sale is ignored for income tax purposes.[23].

3. Gift tax can be avoided (if probability-of-exhaustion test satisfied)

   The value of the private annuity can be determined using IRS actuarial tables, provided that there is not more than a 5% risk of exhaustion of Dynasty Trust assets.[24] With the value of property sold determined, it is possible to avoid a taxable gift on the sale by setting the value of the annuity to be exactly equal to the value of the property sold.[25]

4. Estate tax efficiency if grantor dies prematurely

   Annuity payments end at death. Thus, if the grantor dies before receiving the actuarially expected number of annuity payments, the grantor's estate is depleted, and additional property passes free of estate tax to the Dynasty Trust.

b. Why Even the Healthy Should Consider Private Annuities

Although commonly perceived as a bet on a shortened life expectancy, private annuity sales can be advantageous even when the senior family member is healthy. Considerations include:

1. Income security

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22 Rev. Rul. 77-193; *Fidelity-Philadelphia Trust Company v. Smith*, 356 U.S. 274 (1958).

23 Rev. Rul. 85-13.

24 Treas. Reg. § 25.7520-3(b)(2)(i).

25 Treas. Reg. § 25.2512-8.

By engaging in a private annuity sale, the senior family member is guaranteed a steady and predictable income stream for life.

2. Avoid valuation disputes

A sale for full and adequate consideration need not be reported on a gift tax return, although adequate disclosure does cause the statute of limitations for assessment to begin running.[26] The business then passes free of estate tax and does not need to be reported on the senior family member's estate tax return.

3. Psychological security to do more aggressive planning

With the senior family member's income assured, he or she may be prepared to do additional planning in order to deplete her estate, including by making large taxable gifts.

V. Charitable Remainder Interests and Sale Of A Business: A Union Of Opposites

It is commonly believed that it is difficult, if not impossible, to transfer a business to a charitable remainder trust (**CRT**) and then have the CRT sell the business. Indeed, there are good reasons to proceed cautiously. In many cases, however, the difficulties can be managed or overcome.

a. Advantages of CRTs

There are significant advantages in general to transferring appreciated property to a CRT and having the CRT sell the property. Below are some of the advantages. A detailed description of CRTs and their many requirements and pitfalls is beyond the scope of this outline.

1. Income tax deduction

The donor may be able to claim a charitable income tax deduction (and a gift tax deduction) for the value of the remainder. The deduction may be limited to the remainder's share of basis in some cases, such as if the remainder passes (or may pass) to a private foundation or if the gain from the sale of the property donated would not be long-term capital gain.[27] The amount of the deduction that may be claimed is also limited to 30% of adjusted gross income, or 20% of adjusted gross income if the remainder passes or may pass to a private foundation.[28]

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26 *See generally* Bramwell, "Considerations and Consequences of Disclosing Non-Gift Transactions," *Journal of Taxation* (2012).

27 § 170(e)(1).

28 § 170(b)(1)(C)-(D); 170(b)(1)(H) (defining "contribution base" as adjusted gross income without regard to NOL carryback, which for the most part has been repealed).

2. Shifting of gain to tax-exempt entity

   The donation of appreciated property shifts gain from the donor to the CRT, which is generally exempt from income tax under Section 664(c). The gift is generally not a taxable event.

3. Tax-free sale

   A CRT is not subject to income tax.[29] Thus, the CRT can realize gain from the sale free of sale.

4. Tax-free reinvestment and build-up

   Because a CRT is not subject to income tax, it can reinvest the sale proceeds and earn income free of tax.

5. Deferral of gain

   Distributions from a CRT to the non-charitable beneficiary or beneficiaries (such as the donor) carry out income under tiering rules. Those rules provide that gross income items (such as dividends and interest) other than capital gain are carried out first, before items of capital gain.[30] Thus, the non-charitable beneficiary recognizes gain over time and only if distributions exceed gross income items other than gain. Sometimes, the rate of tax on income from gross income items other than gain (such as qualified dividend income) is less than the rate of tax on gain (such as collectibles gain).

6. Extra deferral through NIMCRUT option

   The CRT can provide that distributions in early years are limited to income in a fiduciary accounting sense.[31] If income in later years exceeds a fixed unitrust percentage in later years, however, the shortfalls in early years can be made up. This enhances the ability to invest tax-free and defer recognition of income until later years.

   It is even possible to flip to a "standard" unitrust payout in some cases.[32] For example, the CRT could be funded with appreciated property and an unmarketable asset, such as a rocking chair. The trust instrument could provide that the CRT flips to a standard unitrust payout upon sale of the rocking chair.

7. Convert ordinary income to long-term capital gain asset

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29 § 664(c)(1).

30 § 664(b).

31 § 664(d)(3).

32 Treas. Reg. § 1.664-3(a)(1)(i)(c).

The non-charitable beneficiary could sell his or her interest in the CRT (for example, to the remainder charity). The CRT interest is treated as a capital asset whose sale qualifies for long-term capital gain treatment if held for more than one year.[33] . If the CRT would otherwise have caused ordinary income to be carried out, the sale can be advantageous. However, the beneficiary's basis will be limited to zero.[34] If the beneficiary and charity simultaneously sell their interests to a third party, the zero-basis rule of Section 1001(e) is technically avoided; however, basis is reduced by the CRT's undistributed income.[35]

8. Summary

A CRT acts in many ways like a traditional individual retirement account, in that it permits tax-free growth and deferred recognition of income. In some ways, it is even better: unlike an IRA, a CRT can be funded with appreciated property rather than cash.

The main economic downside of a CRT is that, to qualify, the remainder must irrevocably pass to charity.[36] The remainder at inception must also be worth at least 10% of the initial fair market value.[37] Given the income tax benefits, however, a donor will often be better off, after-tax, over the long term even without charitable intent. Some financial models demonstrate that after a 25-year period or so, the donor will almost certainly be better off than if the donor had sold appreciated property directly.

b. Challenges with Selling Business Interests through a CRT

There are a number of ways in which the sale of business interests through a CRT can go wrong. Below are some of the considerations.

1. Assignment-of-income doctrine

Gain from the sale of the business can be attributed back to the donor if the sale had ripened to a practical certainty by the time of the gift.[38]

2. CRTs not qualified S corporation shareholders

33 § 1221.

34 § 1001(e).

35 Treas. Reg. § 1.1014-5(c).

36 §§ 664(d)(1)(C) and 664(d)(2)(C).

37 §§ 664(d)(1)(D) and 664(d)(2)(D).

38 For a sobering example, see *Ferguson v. Commissioner*, 174 F.3d 997 (9th Cir. 1999).

A CRT is not a permissible S corporation shareholder. A donation of S corporation shares to a CRT will cause S corporation status to terminate. CRTs subject to confiscatory tax on unrelated business taxable income.[39]

A CRT pays a 100% tax on unrelated business taxable income or UBTI.[40] For a CRT, UBTI will include income from almost any trade or business.[41]

3. CRTs also subject to confiscatory tax on debt-financed income

A CRT also generally pays a 100% tax on debt-financed income, which is generally treated as UBTI under § 514. Debt-financed income can include gain from the sale of assets. It may even include a portion of the gain from the sale of a partnership interest if the CRT had a share of partnership debt.[42]

4. CRTs subject to excise tax on self-dealing

CRT managers and other "disqualified persons" are subject to a punitive excise tax on acts of self-dealing under Section 4941.[43] As self-dealing may occur directly or indirectly, all transactions at the underlying business level must be scrutinized carefully for self-dealing once business interests are transferred to a CRT.

5. Bargain sale

The funding of a CRT with a partnership interest, if the partnership has debt, could trigger a bargain sale, causing gain to be recognized.[44] At least the initial funding of a CRT by bargain sale cannot be considered an act of self-dealing, as the donor is not at that time a disqualified person.[45]

c. Overcoming CRT Challenges

Despite the foregoing challenges, contributions of business interests should still be considered in many cases. Below are some ways in which some challenges can be addressed.

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39 Rev. Rul. 92-48.

40 § 664(c)(2).

41 §§ 512(a) and 513(a).

42 TAM 96-51-001.

43 § 4947(a)(2).

44 Treas. Reg. § 1.1001-2(c) Example 4.

45 Treas. Reg. § 53.4941(d)-1(a).

1. Have S corporation create CRT

   Although CRTs are not permissible S corporation shareholders, the S corporation can itself create a CRT.

   i Income tax deduction and basis adjustment

   The donor, through his S corporation shares, can then achieve tax treatment similar to funding a CRT directly.[46] Each shareholder's basis in the stock is reduced by the shareholder's share of the basis of the property contributed.[47] The shareholder generally receives a charitable deduction equal to the shareholder's share full fair market value of the property contributed, even if that share exceeds the shareholder's basis (although the deduction is still limited if the shareholder's share of basis in the property exceeds the shareholder's basis in the stock).[48]

   ii S corporation and varying interest rule

   To take advantage of the varying interest rule (discussed below), the S corporation could first contribute assets to a partnership, and then donate the partnership interest to a CRT.

2. Manage UBTI through the varying interest rule of Section 706(d)(1).

   If a partnership interest changes hands during a taxable year, Section 706(d)(1) permits proration of income on a daily basis.[49] Unless there is an agreement among the partners, the interim "closing-of-the-books" method must be used.[50] These flexible rules permit the CRT that receives a partnership interest to limit its share of UBTI for the initial partnership taxable year in which the CRT is a partner. This mitigates the impact of the 100% tax on UBTI.

   Of course, sale must occur quickly so on5r8e can to keep UBTI to a minimum.

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46 § 1366(a).

47 § 1367(a)(2) (flush sentence).

48 § 1366(d)(4).

49 Treas. Reg. § 1.706-4.

50 Treas. Reg. § 1.706-4(a)(3)(iii).

	Net Earnings	Total Preferred Allocation 6.67%	Common allocation	Arrearage	Income Tax on Common Profits	After Tax Retained Earnings	Each Son's Capital Account	Daughter's Capital Account
1	$800,000	$600,000	$200,000	0	$80,000	$120,000	$3,000,000	$3,120,000
2	$800,000	$600,000	$200,000	0	$80,000	$120,000	$3,000,000	$3,240,000
3	$600,000	$600,000	$0	$0	$0	$0	$3,000,000	$3,240,000
4	$500,000	$500,000	$0	$100,000	$0	$0	$3,000,000	$3,240,000
5	$800,000	$700,000	$100,000	$0	$40,000	$60,000	$3,000,000	$3,300,000
6	$1,200,000	$600,000	$600,000	$0	$240,000	$340,000	$3,000,000	$3,640,000
7	$1,200,000	$600,000	$600,000	$0	$240,000	$340,000	$3,000,000	$3,980,000
8	$1,200,000	$600,000	$600,000	$0	$240,000	$340,000	$3,000,000	$4,320,000
9	$1,200,000	$600,000	$600,000	$0	$240,000	$340,000	$3,000,000	$4,660,000
10	$1,200,000	$600,000	$600,000	$0	$240,000	$340,000	$3,000,000	$5,000,000
11	$1,200,000	$600,000	$600,000	$0	$240,000	$340,000	$3,000,000	$5,340,000
12	$1,200,000	$600,000	$600,000	$0	$240,000	$340,000	$3,000,000	$5,680,000
13	$1,200,000	$600,000	$600,000	$0	$240,000	$340,000	$3,000,000	$6,020,000
14	$1,200,000	$600,000	$600,000	$0	$240,000	$340,000	$3,000,000	$6,360,000
15	$1,200,000	$600,000	$600,000	$0	$240,000	$340,000	$3,000,000	$6,700,000
16	$1,200,000	$600,000	$600,000	$0	$240,000	$340,000	$3,000,000	$7,040,000
17	$1,200,000	$600,000	$600,000	$0	$240,000	$340,000	$3,000,000	$7,380,000
18	$1,200,000	$600,000	$600,000	$0	$240,000	$340,000	$3,000,000	$7,720,000
19	$1,200,000	$600,000	$600,000	$0	$240,000	$340,000	$3,000,000	$8,060,000
20	$1,200,000	$600,000	$600,000	$0	$240,000	$340,000	$3,000,000	$8,400,000
21	$1,200,000	$600,000	$600,000	$0	$240,000	$340,000	$3,000,000	$8,740,000
22	$1,200,000	$600,000	$600,000	$0	$240,000	$340,000	$3,000,000	$9,080,000
23	$1,200,000	$600,000	$600,000	$0	$240,000	$340,000	$3,000,000	$9,420,000
Total:	**$25,100,000**	**$13,800,000**	**$11,300,000**		**$4,520,000**	**$6,420,000**	**$3,000,000**	**$9,420,000**