

The Milbank logo consists of a solid red square with the word "Milbank" written in white, bold, sans-serif font in the lower-left corner.

Milbank

PASSING ON THE FAMILY BUSINESS: OVERLOOKED TECHNIQUES

by

Austin Bramwell

Jerry Hesch

Joy Spense

Orange County Estate Planning Council
Newport Beach, California
January 22, 2019

Passing On The Family Business: Common Challenges

- Estate Gift Tax
- Estate Tax Versus Basis Step Up
- Retaining Key Employees / Deferred Compensation Plans
- Buy-Sell Agreements With Other Business Owners
- Long-Term Governance – Including With Active Versus Inactive Children

Typical Situation

- Father Is Sole Owner Of Family Business
- Father Has Four Children: Three Sons And A Daughter
- Only Daughter Is Active, the four sons do not participate in the family buisess
- Family Business Is Worth \$12 Million
- Father Has \$4 Million Other Assets
- Father Wants Each Child To Receive Equal Amount Of Wealth
- Father Wants Earnings From Business To Be Reinvested (Except For Salaries)
- After deduction for active child's salary, the business profits for the past have been \$800,000.

Solution I: Pro Rata Bequests Assets

- Each Child Gets An Equal Share Of Business And Equal Share Of Other Assets

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

- Problem: Only the Active Daughter Will Be Working For Family Business
- The Passive Sons Get No Return From Ownership If Earnings Reinvested
- **Looters Versus Moochers Dilemma**

Solution II: Non-Business Assets To Inactive Children

- Passive Sons Get All of Other Assets While Daughter Gets Disproportionate Share Of Family Business

	Family Business	Other Assets	Total
Value:	\$12,000,000	\$4,000,000	\$16,000,000
Each Son's Share:	$\$2,666,667 \times 3 =$ 8,000,000	\$1,333,333	\$4,000,000
Daughter's Share:	\$4,000,000 instead of \$3,000,000 share	\$0	\$4,000,000

- Passive Sons Still Get No Return From Ownership If Earnings Exceed current \$800,000 level
- Father Would Need \$36,000,000 of other assets to equalize distributions to the four children.** If Father has 36,000,000 of other assets, distribute \$12,000,000 each to 3 sons, leaves active child with entire \$12,000,000 value for the family business.

Solution III: Buy Out Inactive Children With Debt

- Each Child Gets A 25% Share Of Business, And Daughter Borrows To Buy Out the three Sons

	Business	Loan Proceeds	Other Assets	Total	Per Child
Sons (Inactive)	\$0	\$9,000,000	\$3,000,000	\$12,000,000	\$4,000,000
Daughter (Active)	\$3,000,000 <i>[\$12,000,000 less \$9,000,000 debt]</i>	\$0	\$1,000,000	\$4,000,000	\$4,000,000

- Solves Moochers Versus Looters Dilemma
- Earnings Can No Longer Be Reinvested – Must Instead Be Used For Debt Service
- Business Financially More Fragile
- Passive Family Members No Longer Share In Performance Of Family Business
 - Daughter gets all upside if business booms
 - **Daughter bears all risk of loss of business fails**

Solution IV: Buy Out Inactive Children With Earnings

- Each Child Gets An Equal Share Of Business And Sons' Interests Are Bought Out With Notes

	Business	Other Assets	Total	Per Child
Sons (Inactive)	\$9,000,000 in Notes	\$3,000,000	\$12,000,000	\$4,000,000
Daughter (Active)	\$3,000,000 [\$12,000,000 less \$9,000,000 in notes]	\$1,000,000	\$4,000,000	\$4,000,000

- Solves Moochers Versus Looters Dilemma
- Solves Problem Of Business Fragility
- Family Members Now Share In Risks Of Family Business
 - Daughter still gets all upside if business booms
- Earnings Still Can't Be Reinvested – Must Instead Be Used To Pay Notes

Father's Life Insurance Broker Has A Solution Too

- Buy Life Insurance!
- Importance Of Defining Objectives Of Life Insurance
- Provide Other Assets To Inactive Family Members?
 - **\$32,000,000 of life insurance needed to provide \$12,000,000 of other assets to each Son** (\$32,000,000 death benefit + \$4,000,000 other assets = \$36,000,000 to provide \$12,000,000 to each of the three sons).
 - Premium costs of insurance inhibits reinvestment of business earnings
 - Premium Cost may be prohibitive, and is not deductible for income tax purposes
 - What if father is in poor health or is not insurable?

-
- Allows Active Family Members To Buy Out Inactive Family Members?
 - \$8 Million Of Life Insurance Plus \$1 Million Other Assets Needed Buy Out Sons
 - If Daughter buys \$8 million of life insurance, then:
 - Daughter can use \$8 million plus her \$1 million share of other assets to buy out Sons
 - Sons get \$9 million from sale of 3/4 of Family Business + \$3 million of other assets = \$12 million
 - Daughter nets \$12 million Family Business = \$12 million
 - Result could be considered fair since Daughter has to pay for insurance during Father's lifetime
 - But this rarely happens and disparate results difficult
 - If Father makes gifts to Daughter (or a trust for her benefit) to buy \$9 million of life insurance, then:
 - Daughter can use \$9 million to buy out Sons
 - Sons get \$9 million from sale of 3/4 of Family Business + \$3 million of other assets = \$12 million
 - Daughter nets \$12 million Family Business = \$12 million
 - Result is not equitable since Father makes gifts solely to Daughter so that she gets a larger inheritance

- If Father Makes Loans To Daughter (Or A Trust For Her Benefit) To Buy \$8 Million Of Life Insurance, Then Problem Is That Loans Must Be Repaid
- Assuming Father Loans A Total Of \$6 Million Plus Interest Accrued Through Death, Then:
 - Daughter can use \$8 million of life insurance death benefit + \$1 million share of other assets to buy out Sons
 - Sons get \$9 million from sale of 3/4 of Family Business + \$3 million of other assets = \$12 million
 - Daughter gets \$12 million Family Business – \$6 million loan = \$6 million net
 - If \$6 million goes to Sons, they get a total of \$12 million + \$6 million = \$18 million net
 - If \$6 million divided equally between Children, then:
 - Sons get a total of \$12 million + \$4.5 million = \$16.5 million (\$5.5 each)
 - Daughter gets a total of \$6 million + \$1.5 million = \$7.5 million
 - Getting economics right is difficult
- Father may need to use earnings to make loans to pay for life insurance

- If Family Business Buys Life Insurance, Then:
 - Value of business as of date of death is augmented for estate tax purposes
 - Earnings of business used to pay for life insurance
 - If redemption price is determined without regard to life insurance, effect is equivalent to making gifts to Daughter
 - Sons get \$9 million redemption proceeds
 - Daughter gets \$12 million Family Business
 - If redemption price includes life insurance proceeds, then \$9 million isn't enough
 - Three-quarters x (\$12 million Family Business + \$9 million of life insurance) = \$15,750,000

- Father Could Create Trust For All Children And Use It To Buy Life Insurance
- Life Insurance Then Acts As Asset Accumulation Vehicle
- But, then \$32 Million Needed To Equalize
- Father May Prefer To Invest Earnings In Business

Practical Issues With Making Life Insurance Work Equalize Active And Inactive Children

- Life Insurance Costs Money
- Life Insurance Earn Returns If Held Through The Insured's Death But Doesn't Multiply Wealth (Short Of Premature Death)
- Difficult To Prove Any Asset, Life Insurance Included, Solely To Active Child Without Creating Inequality

The Preferred Partnership Solution: Basic Elements

- Family Business Capital Structure Is Revised To Create Preferred And Common Ownership Interests
- Preferred Interests Have Priority Return Equal To A Fixed Percentage Of Capital
 - That is, earnings are added first to the capital accounts of preferred owners until their priority is satisfied
- If Earnings Are Insufficient To Pay Priority Return, Preferred Interests Have The Right To Make Up The Shortfall In Future Years
- Balance Of Earnings Go To Common Interests
- Active Owners Have Right To Salary (Guaranteed Payments) For Services
 - Guaranteed payments are a deductible “super-priority” return

The Preferred Partnership Solution: Example

- **Father Revises Family Business's Governing Documents So As To Create Preferred And Common Interests**
 - Note: Father remains sole owner during his lifetime, so there are no gift or other tax implications
- **Preferred Interests Have Priority Return Equal To 6.67% Of Share Of Capital Annually**
- **Father Bequeaths Preferred Interests To Sons And Common Interest To Daughter. Each Child receives a 25% interest with a \$3 million capital account**
- **Daughter Continues to Draw A Modest Salary**
- **Priority Returns Are Distributed Annually**
- **Family Business Typically Earns \$800,000 A Year (After Subtracting Daughter's Salary)**

The Preferred Partnership Solution: Results

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

- Pasivve Sons Earn 6.67% -- Not Bad Fixed Return
- Daughter Gets Salary, an \$80,000 Distribution To Cover Income taxes on her allocation, And Reinvests \$120,000 Of Earnings

The Preferred Partnership Solution: Results If Earnings Drop

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

- Sons Still Earn That Same 6.67% -- Not Bad Fixed Return
- Daughter Gets Salary But No Share Of Earnings

The Preferred Partnership Solution: Results If Earnings Drop And Can't Satisfy Priority Return

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

- Sons' Cash Returns Drop To 5.56% -- Still Not Bad Fixed Return
- Sons Also Get The Right To Have The Shortfall Made Up In Future Years
- Daughter Gets Salary But No Share Of Earnings

The Preferred Partnership Solution: Results If Earnings Rebound

Year	Net Earnings	Total Preferred Allocation 6.67%	Common allocation	Arrear-age	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

- Sons Cash Returns Increase To 7.78% -- Which Makes Up For Disappointing Year 4
- Daughter Gets Salary, \$40,000 Distribution To Cover Taxes, And Reinvests \$60,000 Of Earnings

The Preferred Partnership Solution: Results If Business Booms

Year	Net Earnings	Total Preferred Allocation 6.67%	Common allocation	Arrear-age	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

- Sons Earn 6.67% -- Not Bad Fixed Return
- Daughter Gets Salary, \$240,000 Distribution To Cover Taxes, And Reinvests \$340,000 Of Earnings
- At this point the sons are not sharing in the earnings over the \$800,000 threshold. But, the excess has been reinvested in the business

The Preferred Partnership Solution: Results If Business Booms (Cont'd)

Year	Net Earnings	Total Preferred Allocation 6.67%	Common allocation	Arrear-age	Income Tax on Common Profits	After Tax Retained Earnings
6	\$1,200,000	\$600,000	\$600,000	\$0	\$240,000	\$340,000

- Daughter Gets Salary, \$240,000 Distribution To Cover Taxes, And Reinvests \$340,000 Of Earnings
- If This Keeps Up, Daughter's Capital Account Will Increase \$340,000 Each Year While Son's Capital Accounts Are Effectively Frozen At \$3 Million
- After several years with increased profits, Daughter Will Own More Than 50% Of Capital In The Family Business
- If Family Business Is Sold, More Than 50% Will Go To Daughter

The Preferred Partnership Solution: Buying Out Inactive Partners over time with retained earnings or bank loans

Year	Net Earnings	Total Preferred Allocation 6.67%	Common allocation	Arrear-age	Income Tax on Common Profits	After Tax Retained Earnings
6	\$1,200,000	\$600,000	\$600,000	\$0	\$240,000	\$340,000

- Sons May Wish Earnings To Be Used To Redeem Their Capital Accounts
- They Will Still Earn 6.67% On Capital Remaining In Business
- But They Can Redeploy However Much Of Their Million Capital Account Is Redeemed

Review example of the preferred/common structure

Year	Net Income	Preferred Allocation To Passive Children	Common Allocation to Active Child	Arrearage	Income tax on common income	After tax retained earnings for common interest
1	800,000	600,000	200,000	none	80,000	120,000
2	900,000	600,000	300,000	none	120,000	180,000
3	500,000	500,000	none	100,000	none	none
4	950,000	700,000	250,000	none	100,000	150,000
5	1,250,000	600,000	650,000	none	240,000	360,000
6	1,500,000	600,000	900,000	none	360,000	540,000
7	2,000,000	600,000	1,400,000	none	560,000	<u>840,000</u>
Total						²³ <u>2,190,000</u>

What may happen when the passive children learn the company performed so well?

- How can this potential problem be dealt with? After all, the primary reason for the significant increase in value and earnings was due to the active child's efforts and willingness to reinvest the active child's after-tax share of company profits to grow the business.
- Note that in Year 3 the net income was only \$500,000 so that the active child's common interest received nothing and that the \$100,000 preferred shortfall had to be made up in Year 4 .
- What can be done by Senior in advance to avoid this concern?

Windfalls From Sale Of Business

- Suppose Daughter's Capital Account (Thanks To Reinvested Earnings) Is \$5,190,000. And Each Son's Capital Account Is \$3,000,000, or \$9,000,000 preferred for the three passive children. Total capital accounts are now \$14,190,000.
- Family Business Receives An Offer To Sell For \$25,190,000
- First capital account allocation of sale proceeds: Daughter Receives \$5,190,000 And Each Son Receives \$3 Million
- What About The \$11,000,000 excess over capital accounts. How treat this Windfall?
 - If it's an asset sale, all \$11,000,000 of the windfall goes to Daughter because the gain is partnership income and the entire gain in excess over the preferred must all be allocated to the common
 - If members sell their LLC interests, they can allocate sale proceeds as they agree
 - Family Business governing documents should require membership approval of extraordinary decisions such as sale of assets
- Family Business's Governing Documents Can Determine In Advance How Windfall Is Allocated

In year 8 the business is sold for \$25,190,000 in cash.

- Given that Senior wanted to treat all four children equally, it can be assumed that Senior would have wanted the passive children to share in the windfall the active child created. **Possible solution is to provide that the passive children share in the windfall.**
- Capital accounts

<u>Preferred</u>	<u>Common</u>	
\$9,000,000	\$3,000,000	
	<u>+2,190,000</u>	Retained earnings
	\$5,190,000	

First, distribute the \$14,190,000 according to current accounts. That leaves an \$11,000,000 excess that can be shared by all four children. **Senior must provide in advance that if the business is sold, how the cash received in excess of the existing capital accounts should be shared. For example, the extra \$11,000,000 can be shared 50% to the active child and 50% to the passive children. How the excess is shared is a decision the father should decide in advance.**

A More Equal Partnership: Giving Each Child Both Common And Preferred

- Father Might Want Sons And Daughter To Share More Equally In Upside And Downside
- He Could Do This By Giving Preferred Interests To Both Sons and Daughter
- Example: Allocate all \$12,000,000 of value to the preferred ($6.67\% \times \$12,000,000 = \$800,000$) The first \$800,000 of income must be allocated to the preferred interest.
 - Each of the four children receives 25% of the preferred interest, non-voting
 - Each passive Son receives a 20% common interest ($3 \times 20\% = 60\%$), non-voting
 - Active Daughter receives a 40% common interest. Daughter's common interest confers voting and management control

A More Equal Result

Year	Earnings	Preferred 6.67% shared equally by all four children	Preferred Arrearage	Daughter's 40% Common share	Son's 60% common share	Daughter's Total Partnership Earnings	Each Son's Total Partnership Earnings
1	\$800,000	\$800,000	\$0	\$0	\$0	\$200,000	\$200,000
2	\$900,000	\$800,000	\$0	\$40,000	\$60,000	\$240,000	\$220,000
3	\$600,000	\$600,000	\$200,000	\$0	\$0	\$150,000	\$150,000
4	\$950,000	\$950,000	\$50,000	\$0	\$0	\$237,500	\$237,500
5	\$1,050,000	\$850,000	\$0	\$80,000	\$120,000	\$292,500	\$252,500
6	\$1,200,000	\$800,000	\$0	\$160,000	\$240,000	\$360,000	\$280,000
7	\$1,400,000	\$800,000	\$0	\$240,000	\$360,000	\$440,000	\$320,000
8	\$1,600,000	\$800,000	\$0	\$320,000	\$480,000	\$520,000	\$360,000

• Allocation of the \$800,000 Preferred: \$600,000 to three passive sons and \$200,000 to active daughter

- Preferred arrearages for years 3-4
- In Years 5-8, the three Sons Share In Excess Returns Although Daughter Gets 40% And Sons Get 60%

• If business is sold in year 9, the gain is allocated to the common interest, and shared 60% to three sons and 40% to daughter

S Corporation Solutions

- S Corporations Are Not Permitted To Have Different Classes Of Stock
- But S Corporation Can Be A Partner Of A Preferred Partnership
- Example:
 - S corporation contributes Family Business to partnership with Daughter
 - S corporation receives preferred interests
 - Daughter receives common
 - Father bequeaths S corporation shares to Children
- Active Partner Can Also Receive A Profits Interest As Compensation For Services
 - Example: Daughter receives 20% “carried interest,” i.e., 20% of earnings after preferred returns are satisfied

The Preferred Partnership Solution: Practical And Mechanical Issues

- Active Partners Will Need A Salary To Live On
 - Salary is classified as a “guaranteed payment” and is deductible by partnership
 - Guaranteed payments introduce the Looters vs. Moochers dilemma
 - How to solve?
- Audited Financial Statements Give Inactive Partners Confidence In Financial Reporting
- Patriarch Or Matriarch Should Explain The Plan To Children

When To Implement?

- Example So Far Assumes Father Bequeaths Family Business At Death
- In Many Real-World Situations, Senior Generation Business Owners Have Transferred Business Interests During Lifetime
 - E.g., via gifts to Dynasty Trusts, GRATs, and installment sales
- Considerations:
 - Can valuation discounts be generated for gift or estate tax purposes?
 - Are gifts of partnership interests respected for income tax purposes under Sections 761(b) and 704(e)?
 - If partnership interests are transferred to a grantor trust, is there an assignment of income for *gift* tax purposes?
 - Would creating or transferring interests in a preferred partnership trigger Section 2701?
 - Can a step up in basis be obtained under Section 1014?

Section 2701 And The Preferred Partnership Solution

- Section 2701 Is One Of The Most Complex Sections To Master In Gift And Estate Tax Planning
- It Contains Traps For The Unwary
- Generally, It Can Artificially Increase The Value Of A Gift, Or Deem A Gift To Have Occurred, If Junior Family Members Receive Common Interests And Senior Family Members Retain Preferred Interests
- How To Avoid?
 - Don't transfer interests during lifetime – transfer only at death
 - Transfer 100% of the business interests (and make sure no “applicable family member” thereafter retains a distribution right or an extraordinary payment right)
 - Transfer preferred, retain common
 - Retain rights to salary, i.e., guaranteed payments – for example, Father may want to continue to receive compensation for consulting as a retirement benefit
 - Retain right to “qualified payment,” such as the preferred interests discussed in this example – for example, Father may wish to receive qualified payments as a retirement benefit
 - Estate freeze at death of first spouse?

More Techniques: Private Annuity Sales Even For Healthy Clients

- Private Annuity Sales Often Thought Of As A Strategy For Clients With Diminished Life Expectancy
 - So long as client is not “terminally ill,” an ailing client can still rely on standard actuarial factors
- But A Private Annuity Sale Can Make Sense Even For Healthy Clients
- Senior Family Member Is Guaranteed A Stream Of Income
- Valuation Disputes Avoided
 - No requirement to disclose sale on gift tax return if for fair market value
 - Private annuity terminates at death and is not included in gross estate
 - Interest sold not included in gross estate
- With Income Guaranteed For Life, Senior Family Member May Be More Willing To Engage In Aggressive Planning To Deplete His Or Her Estate
- Watch For 5% Probability-Of-Exhaustion Test
 - With very large gift tax exclusion amounts, the test is easier to satisfy

Installment Sale To Non-Grantor Trust

- A Sale Of A Business Interest To A Non-Grantor Trust Qualifies For Section 453 Installment Sale Treatment (i.e., Gain Deferral)
- If Non-Grantor Trust Resells The Business To A Third Party, Section 453(e) Generally Accelerates Gain realized on the prior instalment sale.
 - Exception if sale to third party occurs 2 or more years after installment sale