

**WHO GETS THE WIDGETS WHEN YOU'RE GONE?
PLANNED AND UNPLANNED BUSINESS SUCCESSION**

**ESTATE PLANNING RETREAT
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Fact Pattern

Don and Sue are married and in their 50s. Don owns and operates a commercial construction business in corporate form. Don and Sue have three children. Their son is age 23 and works in the family business in the field. Their only daughter is age 19, attends community college and lives with her parents. The daughter works part-time in the office performing administrative duties for the family business. Don and Sue's youngest son, age 16, is a full time high school student. Both Don and Sue tell you they are in good health. They were referred to you by their CPA.

Don is paid an annual salary of \$400,000 from the construction business. Sue is not involved in and does not work in the construction business. Don and Sue's assets are listed as follows:

<u>Assets</u>	<u>Estimated Value</u>
Office Building (joint tenants)	\$ 1,500,000
Personal Residence (joint tenants) (net of \$500,000 mortgage)	\$ 1,500,000
Vacation home in Colorado mountains (Sue's name alone)	\$ 750,000
Brokerage Account (taxable – joint tenants)	\$ 250,000
Common Stock Interest in Family Business (Don 's name alone)	\$ 6,000,000
Don owns life insurance on his life	\$ 2,000,000
Retirement plans (Don's name alone)	<u>\$ 1,000,000</u>
Total Estimated Value of Assets:	\$13,000,000

Note: The authors intend this material to be a checklist of topics to consider when any of the scenarios discussed herein arise. This material is neither definitive nor exhaustive of the subjects to be considered; we hope that this material provides a useful starting point for discussions.

I. Business Succession in Crisis

Don and Sue have no estate planning documents or business succession documents in place. Don suffers a major stroke and is medically considered to be permanently incapacitated and unable to manage the construction business.

A. Financial Security for Family – Immediate Concerns of Family

1. Is there a disability insurance policy in effect to provide a source of income for the family?
 - (a) Could Don and/or family qualify for Medicare disability payments?
 - (b) If long term care insurance had been acquired, could Sue make a claim for benefits under the terms of the policy?
2. How to replace Don 's salary?
 - (a) Maybe Sue can begin to work in the construction business as an employee and receive a salary
 - (b) What functions can Sue perform for salary – is there any issue of reasonable compensation from IRS perspective?
 - (c) Can distributions be made with respect to Don's stock ownership?
3. What type of continuing health insurance coverage is available to Don and to the family?
 - (a) Since Don's employment is terminated, COBRA coverage is available for eighteen months but at a direct cost to the family
 - (b) If Sue becomes an employee, she may be able to obtain coverage under the existing health care plan sponsored by the business
4. Need to continue payment of premiums on Don 's life insurance policy – how can that be accomplished?
 - (a) Type of policy that is in effect – can the cash value support the payment of premiums?
5. Retirement plan assets – can hardship distributions be made to Sue?
6. Sue will need significant legal counseling to protect her family's interests

- (a) may need to retain new advisors, including business attorney; personal attorney; insurance professional; one or more CPAs; business appraiser; business consultant

B. Who is Running the Business Now that Don is Incapacitated – Preservation of Value

- 1. Need to appoint someone who will have legal authority to act on behalf of business – this assumes ownership and control are with same person(s)
 - (a) Need to commence conservatorship and guardianship proceedings for Don (No estate planning or powers of attorney were prepared) (CRS § 15-14-301 *et seq.* and CRS § 15-14-401 *et seq.*)
 - (i) Once appointed as conservator, Sue can request court approval to conduct estate planning for Don in light of federal and state estate tax exposure
 - What type of estate planning is permitted under Colorado law? (CRS § 15-14-411)
 - If Sue receives court authorization to make an estate plan for Don, and if the business is conducted in an "S" corporation, consider QSSTs and ESBTs that can be shareholders of stock
 - As the conservator, Sue can exercise Don's control over the entity if he was the owner of a 100% equity interest
 - (b) Sue should secure books and records of business; review entity structure of business and review liability insurance of business from both a long term and short-term perspective. In addition, the following needs to be considered:
 - (i) valuation of business for potential sale and estate planning
 - (ii) contractual obligations and liabilities of business, including lease of business offices
 - (iii) liquidity needs of the business – balance with financial support for family
 - (iv) income and other tax planning issues regarding the business, including dividends vs. distributions; redemption considerations; current tax and business filing obligations

- (v) composition of Board of Directors (if corporation); management team or others running the business
 - (vi) officers of business
 - (vii) any outstanding income tax liability of the business
 - (viii) any personal guaranty obligations signed by Don for third-party loans made to the business
 - (ix) whether Don made any loans to the business and the terms of repayment
- (c) Identify all available options in connection with the preservation of business value
- (i) sale of ownership interests to outside third party(ies)
 - (ii) sale of ownership interests to key employees
 - (iii) sale of assets to third parties or employees
 - (iv) Section 1031 like kind exchange for office building
 - (v) possible merger/acquisition candidates
 - (vi) sale or gifting to family members
 - transfer of ownership interests to trusts for family members
 - (vii) continue to manage while Sue learns the business, including perhaps employing oldest son who works in the business
 - (viii) if there are multiple departments or different segments of the business, consider some type of divisive reorganization so that can divide a business among multiple successors

2. If this is a second marriage situation, there could be intra-family disputes with Sue regarding conservatorship and guardianship proceedings which would affect control of the business

- (a) Consider (CRS § 15-14-315.5) assuming someone other than Sue is appointed as guardian, family dispute is intensified if the guardian seeks to obtain a divorce of Don and Sue as a method to squeeze out Sue from control of the business and thereby control the estate planning

3. If the business is owned by Don and one or more co-owners, then various other issues are presented, including:
 - (a) Whether there is a buy-sell agreement in place that would govern the purchase of Don's interest due to his incapacity (whether in the form of a shareholders' agreement, an operating agreement in the case of a limited liability company, a partnership agreement in the case of a partnership, or other controlling agreement)
 - (b) If Don owns a controlling interest, that gives the conservator for Don's estate the ability to manage the business unless there are voting trusts or voting agreements in place that control voting authority and power

C. Don Dies Intestate – What Happens Now?

1. Conservatorship (and guardianship) ends
2. Who decides upon disposition of body in absence of written directions?
 - (a) Statutory Priority (CRS § 15-19-106) gives the Personal Representative first priority, then spouse
 - (b) A dispute could arise as to who is best suited to be appointed as the Personal Representative of Don's estate because son is qualified to be appointed (CRS § 15-12-203)
 - (i) if son is both Don's and Sue's son, then he would not have the required substantial interest in the estate to raise an objection to the appointment of Sue; he could only challenge Sue's capacity
 - (ii) if son is from a previous marriage, he now has the required substantial interest to challenge Sue's appointment
3. Need a Personal Representative appointed to continue to operate the business. Depending upon the structure of the business, death may have an impact on the business
4. C Corporation
 - (a) In our fact pattern, the business is conducted in corporate form, so the death of Don has no effect if the corporation is a "C" corporation
 - (i) If Don owned a controlling interest, Sue could engage in a post-mortem recapitalization of the corporation into voting and non-voting stock so that Sue can disclaim the non-voting interests to the children to use Don's applicable exclusion amount

- this retains control in the voting stock held by Sue while children get economic benefits, but no management control
 - maybe put a "call" option on the non-voting stock to buy it back from the inactive shareholders when the business has the cash to pay for the stock (or children need college money)
 - if Don owned a controlling interest and Sue disclaimed a minority interest, then the children receive discounted minority interests and Don's applicable exclusion amount has been leveraged
 - Example: Don's 100% interest is worth \$6M. Assuming a 30% discount, Sue can disclaim approximately 47.6% of the equity interest to "pack" Don's applicable exclusion amount. Sue continues to hold the 52.4% controlling interest
- (ii) consider a recapitalization with preferred stock to get fixed dividends to Sue for her financial support
- Watch for non-payment of dividends and all appreciation and value going to other family members. Use various options to control current payment of dividends such as specifying that if the dividends are not paid for a particular number of quarters, the preferred shareholder obtains a vote
- (iii) if Sue retains common stock, but no dividends are declared on the common stock, you can even the playing field by giving Sue some rights to replace the Board of Directors
- (b) Is Section 303 redemption available to pay any estate tax and administration expenses allowable under Section 2053 that are associated with the decedent's death?
- (i) amounts distributed in a Section 303 redemption will reduce the estate tax that is eligible for installment payment under Section 6166
- (ii) if there is a need to raise cash in excess of Section 303 amounts, consider whether a Section 302 redemption is available

- (c) With multiple shareholders, determine who controls the Board of Directors and whether a minority shareholder should have some ability to obtain and retain representation on the Board (whether by cumulative voting or by contract)
- (d) With children from a prior marriage and assets being divided and distributed pro rata, management and control of the business could be deadlocked

5. S Corporation

- (a) Personal Representative can vote Don's stock and then heirs vote after distribution from estate to them
 - (i) need to review rules on eligible shareholders particularly regarding estates and trusts as shareholders
 - only the estate can hold stock for first two years after Don's death and QSST (Section 1361(d)) and ESBT trusts (Section 1361(e)) can be formed and thereafter hold stock
 - if no estate planning was done, all stock passes outright to Sue and if Sue disclaims, some can pass to children through disclaimer and children qualify as shareholders
 - (ii) consider same recapitalization that was reviewed for C corporation to get non-voting stock to children, but remember, can't create a preferred stock class in an S corporation
 - If Don owned non-voting stock or a minority voting stock interest, Sue has only the statutory rights given to a minority shareholder unless additional rights are negotiated with co-shareholders

6. LLC

- (a) Death of a member does not cause either dissociation or dissolution of the LLC (CRS § 7-80-801)
- (b) With a single or multiple member LLC, the court appointed guardian, conservator, or Personal Representative has all the powers of an assignee over the deceased member's interest and if the LLC is a single member LLC, the Personal Representative or the heirs presumably could admit themselves as full members (CRS § 7-80-704)

- (c) Without an operating agreement the management is vested in the members and a majority of interest controls (CRS § 7-80-401)
- (d) Once the heirs receive an assignment of the interest, they could admit themselves as full members. With no operating agreement to determine their rights or their ability to sell the interest, they will remain mere assignees at the mercy of the other members unless the decedent owned a controlling interest (CRS § 7-80-704)
- (e) If the decedent was the only or the last surviving member of the LLC, the successors to his interest are entitled to admit anyone as members, including themselves, if they agree to do so unanimously (CRS § 7-80-701)
 - (i) if Don was not the sole member, then his Personal Representative and heirs receive only an assignee interest with no right to become a member or a manager or to elect a manager (CRS § 7-80-701)
 - (ii) even if Don owned a majority interest, but less than 100%, of the LLC or limited partnership prior to death, his Personal Representative and heirs receive only an assignee interest and the other owners can exercise their voting power to elect new managers and/or members/partners
- (f) To create operating agreements and articles of organization the agent or representative of the incapacitated or deceased member will need to obtain unanimous consent of all the members. If the decedent was the only member, the successors can create documents to define the future business structure and operations. If the LLC had members other than the decedent, the successors remain at the mercy of the other members for buy-sell provisions or admission to membership (CRS § 7-80-209) and (CRS § 7-80-401)
- (g) If this is a second marriage situation and the intestate estate is required to be distributed pro rata as to each asset, then suddenly the single member LLC is converted to a tax partnership with all of the possible income tax problems [Rev. Rul. 99-5]
- (h) Evaluate FICA and related employment tax issues

7. General Partnership

- (a) If the entity is a Colorado general partnership, the partner is dissociated at death and subject to buyout provisions under (CRS § 7-64-701 *et seq.*)

- (b) The partnership dissolves and is wound up under (CRS § 7-64-801 *et seq.*) on the death of the last individual partner under Colorado Uniform Partnership Act (1997), subject to reconstitution by the partners who would include the beneficiaries of the decedent's estate
 - (i) if not reconstituted, then wind-up per (CRS § 7-64-103)
- (c) If the partnership was formed prior to January 1, 1998 and didn't elect to be governed by the Colorado Uniform Partnership Act (1997), the death of a partner is treated under Uniform Partnership law (1930). (CRS § 7-60-131) causes dissolution and winding up of the partnership upon the death of a partner. Upon notice to the other partners, (CRS § 7-60-134) limits the deceased partner's liability to past contributions but not including the decedents' liability for his own actions. The partners and the Personal Representative or heirs can continue the partnership business without liquidation as a continuation of the partnership, and have successor liability for the dissolved partnership's liabilities under (CRS § 7-60-141)
- (d) Consider registration as a limited liability partnership if continued

8. Limited Partnership

- (a) Colorado Uniform Limited Partnership Act of 1981 applies if the partnership was formed after October 31, 1981
- (b) If Don was a general partner, he ceased to be a general partner on the date of his death or the appointment of a guardian or conservator (CRS § 7-62-402(f))
 - (i) a majority of the limited partners may admit one or more general partners (CRS § 7-62-401(2)(a))
 - (ii) if a majority of the limited partners fail to act within a reasonable time to admit a general partner, the court (not the probate court) shall upon the request of any limited partner, admit a general partner (CRS § 7-62-401(2)(b))
- (c) If Don was a limited partner, the successors to his interest can only be admitted as limited partners upon the written consent of all partners, otherwise Don's interest remains an assignee interest (CRS § 7-62-301)
- (d) The decedent's or incompetent partner's legally appointed executor, guardian or conservator can exercise all the partner's rights for the purpose of settling the partner's estate or administering the partner's property, including any power the partner had to give an assignee the right to become a limited partner (CRS § 7-62-705)

- (e) Uniform Limited Partnership Law of 1931 applies if the limited partnership was formed after April 10, 1931, or before that date if it complied with (CRS 7-61-103)
- (f) Consider registration as a limited liability limited partnership

9. Sole Proprietorship

- (a) Review business contracts – Personal Representative has to perform at the risk of default and liability
- (b) Review business insurance coverage for defaults and other issues
- (c) Consider entity restructuring issues for future liability protection and matters related to such restructuring, including assignment of contracts
 - (i) liability through owner’s death will remain unlimited, but protection would apply during succeeding operations
- (d) Want to retain goodwill of the business and the name of the business
- (e) May need to sell or liquidate the business, subject to contractual obligations
- (f) If the business was using a trade name or a “doing business as” (DBA), change such registration to the heirs' names after probate distribution if the business will continue
 - (i) re-title assets held in DBA to heirs after probate distribution if business liquidates
 - (ii) review licensure requirements of decedent for continuation of business

10. Multiple Owners

If Don was a minority owner of the business, what rights are available to his conservator/agent/personal representative/successor-in-interest?

- (a) In a corporate context, dissenters rights may be available (CRS § 7-113-102)
- (b) Continued access to books and records and financial information

- check state law for extent of books and records available for inspection depending upon type of entity
- (c) Annual or special meetings may be called by the minority owner to voice objections or to suggest a sale or redemption or for other business purposes-(CRS § 7-114-301; CRS § 7-80-810)
- (d) Judicial dissolution may be available for various circumstances, including
 - (i) deadlock of Board of Directors, managers and/or owners
 - (ii) irreparable injury to owners may occur
- (e) The terms of any co-owner agreement may minimize conflicts and alter statutory default rights, for example:
 - (i) voting agreements or cumulative voting may provide minority owners with the ability to participate in management
 - (ii) periodic meetings could be required
 - (iii) veto powers could be granted to minority owners to block (but not compel) action
 - (iv) super majority voting for certain actions could be required
 - (v) quorum requirements for Board of Director or manager actions and owner actions could be altered from simple majority
 - (vi) preemption rights could be granted to protect against dilution on issuance of additional ownership interests
 - (vii) mandatory distributions if specified performance earnings levels are achieved, particularly in pass-through entities
 - (viii) liquidity can be created for minority owner through put options granted in an agreement

D. Colorado Intestacy Laws

1. If this is a first marriage and children are of this marriage, then Sue receives 100% of Don's intestate estate and becomes, at a minimum, the ultimate owner of the Don's business interests
 - (a) Don's intestate estate assets may be required to be divided and distributed pro rata

- (b) There is no federal (or state) estate tax on Sue's inheritance of Don's intestate share but maybe Sue should disclaim
 - (c) If Sue is willing to disclaim, evaluate what assets are available and appropriate to disclaim
 - (d) Sue could rollover any retirement plan assets for which she is the designated beneficiary
 - (i) this only works for 401(k) plans if the plan agreement actually permits a rollover, as opposed to a required lump sum distribution
 - (ii) rollover works all the time for IRAs unless Don's IRA was inherited by him
2. If this is a second marriage with children from the first marriage, then Sue receives 50% of Don's intestate estate and the children inherit the other 50% of Don's intestate estate
- (a) If there is a minor child, the mother (former spouse) of the child could be appointed as conservator for the minor child (bad news)
 - (b) Issues arise as to how, if at all, the conservatorship for the minor child could be "extended" beyond age 21 through formation of trusts or limited liability entity ownership assuming mother/conservator is in agreement with such arrangements
 - (c) If assets of Don's intestate estate are required to be distributed pro-rata, then the children receive a portion of Don's business interests and management and control of the business could be deadlocked
 - (d) There may be different beneficiaries designated on the life insurance and retirement plan assets that would effectively give those beneficiaries a greater interest in the value of Don's entire intestate estate, absent Sue's election to take her share of the augmented estate per (CRS § 15-11-201 *et seq.*)
 - (e) In our hypothetical facts, there would be federal estate tax consequences on the division of the intestate estate due to 50% passing to the children
 - (i) Colorado's equitable apportionment statute would exonerate the 50% share passing to Sue and result in allocation of estate taxes only to the share received by the children (CRS § 15-12-916)

E. Life Insurance Issues

1. Who is entitled to the insurance proceeds on Don's death?
 - (a) Was the insurance "key person" insurance to be used to buy-out Don's ownership interest?
 - (b) The business (and the other co-owners, if any) may have been intending (and relying) on the insurance proceeds to help in the transition of the business after Don's death
 - (c) Are there any contracts outstanding that require the insurance proceeds to be used for a specific purpose

F. Post-Mortem Tax Planning Opportunities

1. Liquidity may be provided to pay estate taxes, if any, utilizing some of the following techniques:
 - (a) Section 303 redemption and Section 302 redemption for corporations – discussed above
 - (i) the ratio of the value of the business to the entire estate is critical in determining the availability of this technique
 - (b) Section 6166 permits the deferred payment of taxes for business for 5 years, and spread the taxes over 10 years with a low interest rate (15 years total) *if* qualified heirs agree to keep the business in the family and running for 10 years
 - (i) maximum value for Section 6166 election is only \$1,250,000 for 2007
 - (ii) favorable interest rates are available, but interest is not deductible for federal estate or income tax purposes
 - (c) Section 6161 permits one automatic 6 month extension of time to pay estate taxes
 - (d) Under Section 2032 the estate can use the values determined 6 months after the date of death
 - (i) only available if the aggregate estate assets are worth less on the alternate valuation date than on the date of death

- (e) Section 2032A special use valuation is available for estate or business-owned land if it qualifies for a lower actual use value rather than its "highest and best" use
 - (i) this works especially for farm or ranch land where its highest and best use is development
 - (ii) this would be difficult to qualify for in the case of Don's construction business

II. Business Owner Only Wants Estate Planning and is Not Interested in Business Succession Planning

In this situation, the business owner wants to do only estate planning because the business owner isn't ready to think about, much less pay for, business succession planning. The business owner is not presently prepared to address the non-tax issues related to preparing for succession of the business, including, the ability to give up control of the business; the extent of assets outside the business to provide personal financial security; conflict among family members who are and are not active in the business, and how to deal "equitably" with children who are not active in the business.

- A. What can you do in Don's powers of attorney to help or at least not hurt the succession of the business?
 - 1. Discuss family and employee dynamics and abilities
 - 2. Determine who Don wants to control the business during his incapacity
 - (a) Explain that incapacity could be defined to include being unable to manage his business in a timely and intelligent fashion. This would include being out of the country or in a hospital, as well as mental incapacity
 - (b) There should be an easy test to trigger the limited power of attorney or make it effective upon signing
 - 3. If Don wants someone other than Sue to manage the business, he should prepare a separate limited power of attorney for that person which only grants powers over the business operations
 - (a) Add HIPAA provisions that enable someone NOT appointed as Don's health care agent to get necessary medical information if it's needed to trigger the limited power of attorney
 - (b) Coordinate with powers granted to Sue to avoid conflict

- (c) If nothing else, explain how the business would be managed during his incapacity without any planning. This at least gets him thinking
- B. Recommend a self-executing contractual agreement specifying management succession to be effective upon death
 - 1. The agreement could include a voting agreement; a voting trust; and written consent to action
- C. Considerations for Will provisions
 - 1. If probate of the Will is delayed for any number of reasons, including a Will contest, it is important to specify how the business will be managed after Don's death (see #2 above)
 - (a) Remember that this could be years for a taxable estate, especially if litigation ensues
 - 2. Explain that the Personal Representative will, at most, have only the same authority to deal with all aspects of the business that Don had prior to death, unless specified otherwise (see #2 above)
 - 3. Determine who Don wants to have the ultimate ownership (not necessarily control) of the business after he's gone. As part of the discussions, raise the following issues:
 - (a) Operation of the business without conflict
 - (b) Liquidity of the business to continue
 - (c) Potential sale of the business
 - (d) Cash flow for distributions to support his family
 - (e) Tax costs of a sale or inheriting the business
 - (i) stepped-up basis at death will improve the economics of a post-death sale
 - (f) Deadlock among beneficiaries
 - 4. Some things to think about in drafting the Will include:
 - (a) With an S corporation, the Personal Representative needs express authority to enter into shareholder agreements; S elections or terminations; transfer restrictions and deal with any other S elections

- (b) With an S corporation, need to give the Personal Representative authority to distribute out the S stock in the event it falls into the hands of an ineligible shareholder so that S election is preserved
 - (c) Grant the Personal Representative express authority to engage in corporate recapitalizations (LLC recapitalizations work only if Don owned 100%). Permit the Personal Representative to make non-pro-rata distributions of assets and in-kind distributions
 - (d) Draft specific directions to the Personal Representative relative to any powers and rights they will have for the operation and disposition of the business during estate administration
 - (e) Avoid creating deadlock ownership situations without creating resolution strategies
 - (i) give one beneficiary majority interest
 - (ii) give one person (not necessarily a beneficiary) the ability to break a deadlock/tie
 - (iii) add mediation and arbitration provisions
 - (iv) add Texas shoot-out or buy-out provisions or mandatory liquidation provisions
 - (v) carefully select the trustees who will have the rights and powers associated with the business interests held in trust
 - (f) Keep it flexible – circumstances may be different post-death
 - (g) There is no legal requirement to close probate quickly; the heirs would benefit from receiving the best value for the business
5. If the business is sold post-death:
- (a) The heirs only receive cash
 - (b) One or more heirs could buy the business during this time, using their inheritance, if adequate
 - (i) this might permit one active child to continue the business while retaining equal distributions to children

- (c) Key employees might be given special purchasing terms under the Will that the Personal Representative could offer without a fiduciary breach
 - (d) The Personal Representative could be directed to sell the business within an extended period of time, effectively holding it in trust, to permit a buyer at the best price to be found
 - (i) alternatively, the family could be given a period of time to run the business, and if certain criteria weren't met, the Personal Representative would then be directed to sell it
6. If the business continues to be operated, post-death:
- (a) Include family support provisions during an extended estate administration as well as tax payment provisions
 - (b) Consider appropriate exoneration clauses for Personal Representative
 - (c) Perhaps dedicate additional estate liquidity to the business operations during administration
 - (d) Consider buyout provisions or alternative asset bequests for family members not wanting to continue the business
 - (e) Provide for distributions to family members who own but don't work in the business (Section I, Paragraph C., Subparagraph 10 entitled "Multiple Owners" for minority owner rights)
 - (i) insufficient distributions can create tension between the working family members who get a salary and the non-working family members who feel cheated by small equity distributions
 - (f) Direct family members to utilize the expertise of key employees or professional advisors
- D. For as long as the business exists, Sue should be an employee at some level to maintain health insurance
- E. Marital Agreements
1. Depending upon who receives the business interests at Don's death and the value of the business interests, Sue may need to waive her elective share so that the business does in fact pass to the designated recipient(s) if it is someone other than the surviving spouse

2. If the surviving spouse does not waive the right to be the business owner's Personal Representative, conservator or guardian, the spouse may end up running the business (into the ground?) if he/she has no experience to operate it
3. Unless waived, the surviving spouse has a federal right to be the primary beneficiary on the deceased spouse's 401(k) plan assets which might hold some or all of the business interests
4. The spouse may agree to a voting trust or a lifetime marital trust to be established to hold the business interests with a capable person designated to vote the business interests. The spouse may alternatively agree to accept assignee interests so only the economic benefit is retained
5. Depending upon the value of the business, if the couple does divorce, waiver of the right to receive the business interests in satisfaction of the spouse's rights, could protect the business viability while other assets or assignee interests can provide for any desired support of the spouse
6. Be careful about children from prior marriages who could file for divorce on behalf of an incapacitated business owner and thereby reduce the widow/widower's share under an agreement to that of an ex-spouse. Coordinate appointment of agents with waivers of spousal rights to accomplish the business owner's desires

F. Long term care insurance

III. Sole Business Owner Wants Business Succession

Don has spent time working with his advisors to assist him in planning for the succession of the business. As a result of the advice he has received from his advisors, Don and Sue are ready to address not only estate planning matters but also succession of the business utilizing certain planning techniques.

A. General Concepts to Discuss with Don and Sue Include:

1. Longevity, financial security and flexibility
2. Management vs. ownership – two different propositions
3. Transfer tax concepts
4. Income tax concepts (basis step-up; carryover basis)
5. Lifetime gifting – annual exclusion; lifetime exclusion; medical and tuition payments

6. Asset balancing
7. Fractionalizing ownership and valuation discount planning
8. Equalizing provisions for beneficiaries some of whom may chose not to participate in the business
9. Life insurance on Sue's life and ownership of insurance on both Sue's and Don's life
10. Marriage and divorce of children and other descendants and related "asset protection" issues; require marital agreements for children
11. Charitable inclinations
12. Liquidity for taxes and financial security
13. Trusts and trustees
14. Treatment of key, loyal employees
15. Majority vs. minority ownership
16. Estate freezing
17. Leverage of exclusion amounts
18. Ability of client to administer planning technique properly
19. Future of transfer taxes
20. Future of income taxes and capital gains
21. Valuation of the business (Rev. Rul. 59-60)
22. Hire children to provide non-gift income
23. Marital agreement between Don and Sue

B. Maintain Services of Key, Non-Family Service Providers

1. Employment agreements to provide security to key employees and assurance to business upon owner's death or incapacity
2. Retention bonuses to keep talent, but not minority ownership interests

3. Define the role key employees play in succession
4. Consider non-family board members and/or advisory board members
5. Use of "profits interests" to groom key employees to become successor owners without the need to raise cash

C. Toolbox

A toolbox of succession techniques is available to accomplish the business owner's desired objectives

1. Life Insurance Trust for Don's Life Insurance -- need to evaluate:

- (a) Type of policy involved (term, universal, etc.)
- (b) Cost of premiums and structuring premium payments through use of "Crummey" powers
- (c) How to determine the gift tax value of policy (term value is pro-ration of remaining premium and cash value policies determined pursuant to IRS rulings and treasury regulations)
- (d) Application of three-year rule under Section 2035 which includes death proceeds in the transferor's estate if death occurs within three years of transfer
- (e) Whether there are any contractual obligations required to be satisfied by insurance proceeds
- (f) Liquidity available to pay estate tax
- (g) Structure of trust to accomplish all of the foregoing objectives

2. Transfer Office Building to Tax Partnership

- (a) Ascertain the most beneficial state law structure of the tax partnership, for example, limited liability companies (LLC); limited liability partnerships (LLP); limited partnerships (LP) and limited liability limited partnerships (LLLP). Considerations include:
 - (i) payroll tax issues depend upon the type of interest owned and the level of participation by the owner in the operation of the entity (proposed treasury regulations, which are under review, outline the factors to consider)

- (ii) the ability to deduct passive losses
 - (iii) the level of liability protection for the business managers depends upon the type of entity
 - (iv) whether operations in another state (or real estate owned in another state) will change the limited liability protection for the owners of an LLLP
- (b) Provides limited liability protection
 - (c) Can gift ownership interests at a discounted value for gift tax purposes and to reduce the value of Sue's gross estate
 - (i) be sure Sue does not have any retained interest in the assets she contributed (including her inherited assets) to the tax partnership so as to avoid Section 2036
 - (ii) assess whether the family understands and is willing to comply with all of the formalities required to properly operate the tax partnership as a separate entity (not a sham) and to effectuate the discount planning
 - (d) Consider creating two classes of ownership interest; one voting interests and one non-voting interests (inherent in a limited partnership, but optional in a limited liability company)
 - (i) either Sue can retain control by retaining the voting interests and give discounted non-voting interests or Sue can gift the voting interests and retain the economic benefit of the non-voting interests with a discounted value for federal estate tax purposes
 - (e) If trusts are owners, consider timing of distributions to beneficiaries and identity of trustee who controls the interest prior to distribution
 - (f) Review the family partnership rules under Section 704(e) for owners who are minors
 - (g) Beware of UTMA ownership because the custodian has control over the ownership interest and the minor receives the interest outright at age 21 (CRS § 11-50-101 *et. seq.*)
 - (h) Can generate cash flow through leasing arrangements with the business

3. Recapitalize the Business During Life

- (a) Voting vs. non-voting interests and gifts
- (b) Type of trust and special rules for S corporations, see Section I, Paragraph C, Subparagraph 5 and Section IV, Paragraph 3
- (c) See discussion of analogous issues in Section I, Paragraph C., Subparagraphs 4 and 5

4. Installment Sale to Family Members

- (a) Sale for full and adequate consideration to family members in exchange for promissory note which is paid through distributions of profits or income of the business
- (b) Freezes the value of the business in the seller's estate to the value of the promissory note and any unspent payments
- (c) Consider the income tax consequences of sale – capital gains realized by seller and purchase price tax basis for purchaser

5. Installment Sale to Grantor Trust

- (a) Involves sale of business interest to a trust structured as a grantor trust for income tax purposes in exchange for a promissory note (Rev. Rul. 85-13)
- (b) Fund the trust with "seed" assets – to protect status of promissory note as true debt rather than equity in the trust
 - (i) file a gift tax return to start statute of limitations on valuation and make adequate disclosure
 - (ii) can make the trust exempt from generation-skipping tax by allocating the grantor's GST exemption to "seed" money
- (c) Promissory note can be structured with interest only and a balloon payment of principal to maximize the growth of the assets in the trust - if the promissory note is self-canceling, include a premium for the self-canceling feature
 - (i) need cash flow from the business to make note payments
- (d) Need strong appraisal of the business interest sold to avoid part sale-part gift re-characterization

- (e) Add provisions to make the trust a grantor trust for income tax purposes and terminating grantor trust status off
- (f) Use of Section 1274 applicable federal rate (lower than Section 7520 rate)
- (g) Estate freeze objective - grantor's estate includes only the value of the promissory note at date of death plus any unspent payments

6. Grantor Retained Annuity Trust (GRAT)

- (a) Able to zero-out the gift using a Walton-type GRAT
- (b) The GRAT transfers appreciation in excess of the retained annuity value – this is the excess over the Section 7520 rate if it is a Walton-type GRAT
- (c) Review carefully the rules for obtaining a marital deduction for the GRAT assets if the grantor dies during the annuity term - this must be coordinated in the grantor's Will
- (d) Design length of annuity term and whether the annuity payments should be fixed or increasing
 - (i) the annuity term should be less than the grantor's actuarial life expectancy
 - (ii) the annuity payments can increase by 20% per year
 - (iii) need cash flow from the business to make the annuity payments to the grantor
- (e) During the retained annuity term, the grantor cannot allocate any portion of his or her GST exemption amount
- (f) Grantor trust status can continue beyond the annuity period so that grantor can continue paying the income taxes on the GRAT income without gift tax consequences
 - (i) reimbursement of income taxes paid by grantor during annuity term (Rev. Rul. 2004-64)
- (g) To start statute of limitations on valuation, file a gift tax return with adequate disclosure and consider reporting a small gift rather than zeroing out the GRAT
- (h) Need strong appraisal of the business interest

- (i) consider continuing the GRAT trust after the expiration of the annuity term so that the trustee controls the business interests and the distributions
7. Charitable Planning – Charitable Remainder Trusts and Charitable Lead Trusts are effective tools to make charitable gifts and reduce income taxes
8. Divert Future Business Opportunities
- (a) Consider what additional business opportunities could be developed in a separate entity owned by family members (or trusts or entities established for family members)
 - (i) Example: Using a Franchise Business
 - Create new limited liability entity owned by other family members or trusts for family members
 - Founder then loans funds to new entity for operations and enters into agreements to management the business (consulting, management and other agreements) for compensation
 - Entity value grows as a result of Founder's expertise while value is excluded from his or her gross estate
9. Create Separate Entities for Different Types of Assets
- (a) "Investment" type assets like real estate or intellectual property can be segregated from operating business assets so that we can accomplish the following objectives:
 - (i) equalize estate among children who are active in business and children who are not active in the business
 - (ii) make gifts of entity that owns the investment assets to the children who are not active in the business
 - (iii) if transfers are done early, growth goes to the children

IV. Multiple Business Owners

When the client is a business owner wanting to do full estate planning and business succession planning, but has co-owners, all the tools that are available to the sole owner are still appropriate if the co-owners agree and cooperate. The following ideas are in addition to the suggestions made for a sole owner and are applicable only where there are multiple business owners, whether they are partners, members or shareholders.

- A. Buy-Sell Agreement: This is probably the single most important business succession/estate planning tool for multiple owners of a business. Many articles and books have been written on how to structure and draft these agreements, which may also be called shareholder agreements or found in operating agreements and partnership agreements. Here are a few buy-sell issues specifically related to estate planning:
1. If the price agreed to in a buy-sell agreement is not accepted by the IRS as the fair market value for the decedent's estate, the estate ends up paying estate taxes on a value different from what it received under the agreement
 - (a) Those beneficiaries who are affected by the increased estate tax will be determined by how the estate tax is apportioned under the dispositive instrument or state law
 2. For the buy-sell agreement price to be binding for estate tax purposes, the following requirements must be met:
 - (a) The price must be fixed and determinable under the agreement
 - (b) The agreement must be binding on parties both during life and after death
 - (c) The agreement must have been entered into for a bona fide business reason
 - (d) The agreement cannot be a substitute for a testamentary disposition and
 - (e) The agreement must be comparable to similar arm's length arrangements - *Estate of Blount v. Comm*, 428 F.3d 1338 (11th Cir., 2005). See also Section 2703.
 3. Options for purchasing a deceased or disabled owner's interests can be in the form of a corporate redemption, cross purchase by other owners, or a combination. Prices, any valuation determinations, payment and delivery terms along with the remedies for failure to perform should be clearly defined in the agreement
 - (a) Often the company is given the first right of purchase and then the remaining owners can elect to purchase what the company did not. The company's purchase should be designed to qualify as a complete redemption of the owner's interest under Section 302
 - (b) After the company's rights of first refusal are determined, the owners are typically given the right to purchase pro rata shares of the available interests based upon their current ownership percentage, with their rights adjusting for the number of owners electing not to purchase such interests

- (c) If there are only two owners, a “Texas shootout” may be appropriate to avoid deadlock. Here, one owner makes an offer to purchase the other owner’s entire interest or sell his or her entire interest for the same price. The offeree then chooses whether to sell or buy. In this manner, only one owner is left owning the entire company
 - 4. Puts and call rights can be used to create exit alternatives for any equity owners. The circumstances in which the put and call rights are triggered vary by the owners' desires. Call rights create the ability for controlling owners to buy out minority owners and put rights create the ability for minority owners to liquidate their interest
- B. Transfer Restrictions: Many times the provisions for a buy-sell agreement are contained in the transfer restrictions of an operating agreement, partnership agreement or the bylaws
- 1. Any free-standing buy-sell agreement, and any estate planning transfers, must coordinate with transfer restrictions stated in a partnership or operating agreement or corporate bylaws
 - 2. Any intended recipient of a business interest should qualify for full ownership rights as opposed to only assignee rights. This is best to address while the owner is still living and can negotiate his desired estate dispositions with other owners. In particular, if the current owner holds a majority voting interest, he can often dictate his desired dispositions through his control to alter the board of directors or managers, or to amend the controlling documents
- C. S Corporation Shareholder: If the decedent owned shares in an S corporation, each intended recipient of the deceased (or disabled) owner’s interests needs to qualify as an S corporation shareholder
- 1. The estate qualifies for two years following the death of the owner
 - 2. Each individual recipient will be a qualified S shareholder
 - 3. Each recipient trust must qualify as either an Electing Small Business Trust (ESBT) or a Qualified Sub S Trust (QSST) under Section 1361
 - 4. No partnership or limited liability company can own S corporation shares
 - 5. Another S corporation can be a qualified shareholder only if it owns 100% of the S corporation’s stock and qualifies the owned S corporation as a Q Sub under Section 1361

6. While certain family members can qualify as one shareholder, care must be taken so that when all owners' estates are distributed the corporation still has less than 100 countable shareholders, see Section 1361(c)

D. Funding the Buy-Sell Agreement:

1. The first issue is to determine what funds will be available to fund the buy-sell purchase
 - (a) Funds can be obtained from cash flow of the business itself
 - (b) Wealthy owners may have the funds to purchase other owner's interests
 - (c) Often funds are obtained from insurance proceeds on the deceased or disabled owner
2. The second issue is to coordinate the buy sell agreement with the funds needed to complete the purchase. The structure must require parties to purchase the decedent's interest who have the necessary funds
3. The third issue is to minimize or eliminate the tax consequences
 - (a) You must consider income tax to the business and surviving and deceased owners. This could include:
 - (i) a transfer for value under Section 101, causing insurance proceeds to be taxed as ordinary income to the recipient
 - (ii) capital gains or ordinary income to be recognized by a seller of the business interests
 - (iii) carryover or adjusted tax basis for the recipient of the business interests
 - (iv) premium payments could be treated as either a loan or compensation from the company
 - (b) A purchase of company interests by the company could be treated as a dividend (taxed as ordinary income) a purchased interest does not qualify as a redemption of the deceased owner's interests under Section 302
 - (c) The company's purchase payment could be treated as income in respect of a decedent (IRD) and taxed as ordinary income if it is considered payment for past services rendered (compensation or bonus)

- (d) The decedent's estate could include the value of both his ownership interest and the purchase price of his ownership interest (double inclusion), or the ownership interest could be inflated for insurance proceeds received by the business, if the structure is not carefully crafted. See Estate of Blount v. Comm, 428 F.3d 1338 (11th Cir., 2005)
- (e) Transfer of existing insurance policies and payments of future premiums related to a buy-sell arrangement could incur gift taxes
- (f) If the decedent owner had any incidents of ownership in the insurance policy on his life (other than as the business manager), the proceeds could be taxed in his estate along with the value of his business interests, Section 2042
- (g) Terms of the purchase should be designed to provide the deceased owner's family with needed cash flow while not straining the business or other owners' financial standing. Often an immediate small percentage of payment in cash followed by most of the purchase price in a promissory note payable over an extended term is most satisfactory for all parties

E. Life Insurance: Insurance proceeds are a common tool for funding a buy-sell agreement, because the policies are often affordable and can provide large amounts of liquid funds needed to purchase the decedent's interest without encumbering the business with debt

1. Life insurance trusts can hold insurance policies. Trust provisions can provide for distributions to accomplish a multitude of buy-sell structures. These may include purchasing and either holding the decedent's company interests or distributing such interests to the surviving owners, paying off company debt guaranteed by the decedent, and loaning or distributing funds to the company or other owners to purchase the decedent's interests
2. If an owner personally owned a policy on his life prior to a transfer to an insurance trusts, the insured owner must survive three years after transfer and have no incidents of ownership over the life insurance policy owned by the trust at his death, to avoid inclusion of the insurance proceeds in his taxable estate under Sections 2035 and 2042
3. The policy transferred should be one that is expected to continue long enough past the three year period to make the transfer costs worthwhile, such as a level term policy that will have drastically increased premiums within three or four years of transfer
4. The premium payments to a trust can be paid by the company (may be considered compensation to the insured) or by the insured as a gift. Either way, minimizing tax is essential in the design

5. Instead of a life insurance trust, a partnership may be created by the business owners for the sole purpose of holding cross purchase insurance policies. Partnerships can distribute policies to partners without taxation of the proceeds as a transfer for value under Section 101. Premium payments made by the insured individuals would then be considered contributions to the partnership affecting their capital accounts, or treated as loans to the partnership with imputed interest
6. In view of recent rulings for third party purchased insurance, consideration should be given to the insurable interest of any entity owning life insurance, whether the company, a trust or a partnership
7. If the insured owner is also an employee of the company, the new Pension Protection Act of 2006 may cause the insurance proceeds to be taxed to the corporation as ordinary income reduced only by premiums and other amounts paid by the employer for the policy Section 101(j)

V. Business Succession for Attorneys

If the business owner is an attorney engaged in private practice, the following additional considerations must be included in designing any exit strategy under the scenarios above.

A. Attorney becomes Incapacitated

1. Colorado Rule of Professional Conduct 1.16 Declining or Terminating Representation should be reviewed by any partners of the incapacitated attorney. See ABA Formal Opinion 03-429
2. Family members are not bound by ethical rules, but could be counseled to abide by them as a "best practice"
3. Steps need to be taken to provide reasonable assurance that the attorney's impairment will not result in breaches of the Rules of Conduct
 - (a) If the Rules have been violated, an obligation may exist to report the violation to the appropriate professional authority
 - (i) Rule 5.1 Responsibilities of a Partner or Supervisory Attorney
 - (ii) To the extent making such a report would involve the disclosure of client confidences under Rule 1.6 Confidentiality of Information, the reporting attorney would need to obtain client's consent
 - (b) If the firm removes the impaired attorney in a matter, the firm may have an obligation to discuss with the client the circumstances surrounding the change of responsibility for the client's work

- (c) If the impaired attorney resigns or is removed from the firm, the firm may have disclosure obligations to clients who are considering whether to continue to use the firm or shift the relationship to the departed attorney but the firm can only provide statements that have a factual foundation. See Rule 1.4 Communication
- 4. If the impaired attorney is not in the same firm, ABA Formal Opinion 03-431 states that the unimpaired attorney may consult with mental health care professionals in order to determine how to proceed and may also contact Colorado's attorney assistance program
 - (a) the unimpaired attorney may have a duty to report to the appropriate professional authority if the attorney's impairment raises a substantial question as to fitness to practice law (Rule 8.3 Reporting Professional Misconduct)
- B. Sale of Law Practice
 - 1. Colorado Rule of Professional Conduct 1.17 permits an attorney to sell his/her entire law practice only to one or more attorneys licensed in Colorado under certain circumstances
 - 2. See ABA articles on the subject located online at <http://www.abanet.org/media/youraba/200603/article01.html>, <http://www.abanet.org/media/youraba/200606/article01.html> and <http://www.abanet.org/media/youraba/200611/article11.html>
- C. Withdrawal and Wind Down of Law Practice without Selling - issues stressed in various State Bar opinions include:
 - 1. Rule 1.4 Communication
 - 2. Rule 1.6 Confidentiality of Information
 - 3. Rule 1.15 Safekeeping Property
 - 4. Rule 1.16 Declining or Terminating Representation
 - 5. See ABA Formal Opinion 1384 (1977) Disposition of a Attorney's Closed or Document Files Relating to Representation of or Services to Clients
- D. Death of a Practicing Attorney
 - 1. An attorney has an obligation to prepare a plan providing for maintenance and protection of client's files and property in event of attorney's death, which, at a minimum, should include a designation of another attorney who would have

authority to review client files, determine which client files need immediate attention and how to proceed with notification to client regarding death of attorney. See ABA Formal Opinion 92-369 Disposition of Deceased Sole Practitioner's Client Files and Property which describes duties of attorney who assumes responsibility for deceased attorney's client files. Also see "When a Lawyer Dies" (March 2006) article on www.abanet.org as referenced above

2. Governing documents of the professional service company must contain provisions requiring the shareholder, partner or member who withdraws or ceases to be an eligible owner of the professional service company to dispose of his/her equity interest as soon as practicable to either the professional service company or to another duly licensed attorney . See Colorado Rule 265 Professional Service Companies

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