BOVE&LANGA
LAW FIRM

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To: Clients and Friends
From: The Attorneys at Bove & Langa
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# THE BOVE & LANGA REPORT

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## WHAT'S HAPPENING HERE

*Internal Combustion*: Many of you have had the opportunity to speak with Kristan O'Keefe, our new Executive Assistant working with Alexander and Melissa. Her quick mind and calm demeanor has fast proved to be a powerful, effective combination to assist us in providing you the best service we can. Thank you for making her feel welcome. Read more about Kristan at "Support Staff" (www.bovelanga.com).

*The Pressure is On*! Once again New England "Super Lawyers" has honored Alexander and Melissa with recognition in the field of Trusts & Estates. Kelly, too, has maintained her well-deserved status as a "Rising Star".

*Out and About*: Alexander's January presentation on *Trust Protectors* at the annual Heckerling Tax Institute met with great success, having about 1,000 attendees and as many kudos. Closer to home, Melissa has assumed the responsibility of co-chair of the Brookline Community Foundation's Professional Advisors Committee where she will coordinate the committee's function in advising the foundation on matters regarding legacy gifting and other charitable giving.

*Legal Eagle*: Due to her involvement in the Boston Bar Association's Trust and Estates Section Steering Committee, Kelly has had the opportunity to lecture to a number of organizations on the status of several bills which will impact the trusts and estates world that are currently pending at the State House. Additionally, Kelly recently lectured on the new homestead laws which went into effect last March.

# ALL IN THE FAMILY (BUSINESS)

Since so many of our clients and friends are involved in or with a family business, we felt it would be helpful to devote this issue of The Bove & Langa Report to some of the numerous issues and options the founders of the business may consider in making a lifetime transfer of some or all of the business to the next generation. As will be seen, the possible options range from outright gifts to an arrangement where the founding generation can continue to receive lifetime or long-term income after the transfer, all while keeping the business in the family, and perhaps realizing some tax savings to boot. But, while tax savings can be implicit in a succession plan, those savings are not our primary focus here. For ease of reading, we will refer to the generation who started and grew the business as the "creator" -- in recognition of both the creative force required to build a business as well as the often god(dess)-like control which invariably made the business a success. The benefactor of that creative force, the succeeding generation, will be referred to as the "apprentice". Of course, there can be more than one creator and multiple apprentices.

**It Takes More Than A Handshake:** Once the creator has made what is often a difficult and emotional decision to begin the transfer of a family business to the apprentice, the next question is *how* to make the transfer. Of course, there are a number of options to choose from depending on the creator's goals. For example, the "*I'm all done*" creator may wish to transfer the business without any strings attached. Next stop Cannes! Alternatively, the "*Are they ready*?" creator may feel that the apprentice will not be adequately invested in the success of the business unless he has been asked to purchase the interest he receives. Next stop a review of the financials! As you read on, remember that any transfer to the apprentice can be made outright or to one or more trusts for the apprentice's benefit, and all references in this section of the Report to transfers include both options.

*Outright Transfer*: The creator has labored hard for many years to build the business, working with financial advisors to build an outside portfolio sufficient to maintain her lifestyle without the need for continued business income. Here, an outright gift is simple and efficient. The creator transfers the business directly to the apprentice who will run the business. It could be as simple as having the business valued by a valuation expert, and signing a transfer document. Afterwards, the creator would file a gift tax return with the IRS to disclose the gift and pay any gift tax that would be due if the lifetime gift tax exemption did not fully shelter the gift. If an apprentice was a grandchild, generation skipping transfer tax exemption would also be allocated on this return. For example, creator has a $5 million lifetime gift tax exclusion (2012), and gifts a $3 million business. No out of pocket gift tax would be paid with the filing of the gift tax return, and the creator's lifetime gift exclusion amount is reduced to $2 million. Generally speaking, the apprentice would have a basis in the acquired business equal to the creator's basis, but sometimes this can be increased by transaction costs and gift tax if actually paid. Once the gift is complete, any future appreciation in the value of the business due to the apprentice's efforts will be excluded from the creator's taxable estate. Simple? Well, not always. We discuss later what to do when not all children are apprentices.

*Private Annuity*: What if the growth of the business has required the constant infusion of profit back into the business? A lifetime of work and profit contained within the bricks and mortar of the business. The

outright gift of the business to the apprentices can offer a sense of pride and confidence in seeing that the family business will carry on, but here the creator needs an option which provides continued benefit, and the private annuity can provide that extra benefit, for both the creator and the apprentice. This transaction involves a transfer of the business interest to the apprentice (or in some cases where a corporation is involved, to the corporation itself) in return for the private annuity. A private annuity is in some respects similar to a commercial annuity (i.e., one purchased from an insurance company), but the payor is (typically) the apprentice family member, rather than the insurance company. And unlike a commercial annuity, a private annuity can be exchanged for virtually any type of property, including shares of the family business. The good tax news is that if the creator- annuitant dies before the full amount is paid, the balance is excluded from the creator's estate for estate tax purposes -- a substantial tax loophole for a creator who is not in the best of health (which often motivates a creator to think about transition planning). The bad news is that a fairly recent proposed tax regulation provides that entering into the transaction will cause the creator to recognize immediate gain on the transferred business interest as if it were sold for cash. Nevertheless, there is a way to lessen the burden of the tax, and ways to provide the liquidity to pay the tax, and payment of the tax up front could prove beneficial. For instance, it means that future payments on the annuity would be tax free in large part (only the interest – currently very low – would be taxed). Intrigued? See Alexander's article on private annuities on our website under "Articles".

*Outright Sale in Exchange for a Promissory Note*: What if the creator does not like the upfront cost of the private annuity but still wants an income stream? The business could be sold to the apprentice in exchange for a promissory note. There are two types of promissory notes traditionally used in this type of transaction:

> Traditional Promissory Note: This is exactly what it seems - the apprentice would deliver a promissory note to the creator in exchange for the business interest sold. The note would bear interest at the "applicable federal rate" - determined under tables issued by the IRS. The note provides much flexibility, because it can be drafted in numerous ways. For example, the note might be "interest only" with all principal due in a single "balloon payment" at the end of the note. Alternatively, all interest and principal can be due on demand, or both can accumulate to be paid upon maturity of the note. Yet another option is to amortize the principal and interest payments over a term of years. Regarding taxes, the creator would report the interest as income when received; and the apprentice's basis in the business is generally the purchase price.
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> Self-Cancelling Installment Note (SCIN): Another promissory note option rivaling but somewhat similar to the private annuity is the self-cancelling installment note. The SCIN includes a special provision that should the creator die before the note is paid in full, any outstanding balance is cancelled. (Poof!) The unpaid balance (like the private annuity) is excluded from the creator's estate, though unlike the private annuity, the estate must recognize the gain that would have resulted had the full balance been paid. The other side of that coin is that the apprentice gets a cost basis equal to the amount of the note, even though the apprentice may not have actually paid that amount due to the cancellation feature of the SCIN. A slight disadvantage of the SCIN is that the interest rate must be adjusted upwards to reflect two important factors: (i) the full amount of the note may never be paid, and (ii) the creator's age at the time of the transaction. But, at today's low interest rates, it will still be a bargain.

*Part Gift/Part Sale*: Here the creator wants the apprentice to "have some skin in the game" but wants to lessen the financial pressure on the new generation in charge. In this case, the apprentice receives a portion of the business as a gift, and only a part is structured as a sale (private annuity, SCIN, traditional promissory note, etc.). This technique is also good where there is insufficient lifetime gift exclusion to shelter a gift of the entire business interest moving to the apprentice.

*Grantor Retained Annuity Trust (GRAT)*: The apprentices are getting restless, when will they get a piece of the action? When the creator wants the apprentice to know the transfer is going to happen to him, but it is not happening just yet, then a "grantor retained annuity trust" (or "GRAT") is a wonderful choice. The creator transfers the business interest to the GRAT in exchange for annuity payments paid from the GRAT over a number of years (the "term"). Typically income earned by the business will be used by the trustee of the GRAT to make the annuity payments, and, at the end of the term, the apprentice receives the business interest. Once the GRAT is signed, the apprentice knows the date the business interest will be his (after the GRAT term ends).

**I'm Not Quite Dead!** In all of the examples above, the creator can restrict the control the apprentice has over the business or the creator can begin to include the apprentice in the control of the business. It is up to the creator. Any business interest can be reorganized to have both voting and nonvoting interests. Transferring nonvoting interests to the apprentice in any technique discussed above gives the next generation a stake in the success of the company, while the creator retains the voting control and calls the shots. Control beyond the grave? Think "trusts".

**Piece of Cake! Or Is It?** The decision to transfer the business to the apprentice via a trust is more complicated than it appears because, in addition to deciding how the business will eventually be distributed to the apprentice, there are a number of income tax issues to consider. If the trust is designed as a so-called "grantor trust", the creator would be considered the owner of the trust assets for income tax purposes, meaning the creator would pay the annual income taxes owed by the trust. There are several benefits of designing the trust in this manner. For example, the trust assets would not be depleted each year by way of payment of income taxes (often at a federal income tax rate of 35%) and the creator's payment of the trust's income tax further reduces the size of the creator's taxable estate without gift tax consequences. Thus, it is like making a gift-tax-free gift to the apprentice (the beneficiary of the trust). And, if the transaction is structured as a part gift/part sale to a grantor trust, there is no gain to the creator on the sale because it is treated as a sale to himself, which is income tax neutral.

If the creator is not interested in incurring this ongoing income tax liability, then the trust could be designed as a "non-grantor trust" and would pay all income tax obligations from the trust property to the extent the income tax obligations did not flow through to a beneficiary who received a distribution in that year. And, because the creator would not be considered the owner of the trust assets for income tax purposes, the creator would recognize gain on the sale of any portion of the business to the trust in the year of the transfer.

**What's It Worth To You:** When asked, most of our clients tell us that their business is worth very little. We understand where a creator is coming from – in many cases the business has been built from the ground up, family members ("human capital") are considered the biggest asset of the company, and it may appear from the business's tax return that the business itself is not very valuable due to the many tax deductions shown on such a return. For purposes of structuring a transfer, however, every business has a value which must be determined by obtaining a proper "business valuation". This is essential in the event the IRS questions the transfer, or if you include a gift as a part of the transition transaction. Many factors impact a business' value, especially where the value of a transferred minority interest is involved – kids, don't try this at home! Always use the service of a professional valuation expert.

**All Children Are Created Equal.** Oftentimes it is easiest to implement any of the aforementioned transfer techniques when all of the children are involved in the family business as apprentices and the creator transfers the business interests to the children equally. However, complexities may arise when one or more of the children are not involved in the family business. For example, Greg, Jan, Bobby, and Cindy are actively involved in Brady Architecture, Inc. ("Brady Architecture") as apprentices. Marcia and Peter have chosen different career paths and have no interest in Brady Architecture. (Marcia, Marcia, Marcia!) Mr. and Mrs. Brady would like to transfer some membership interests in Brady Architecture to their apprentice children and have decided to gift a portion of the business interests to each of Greg, Jan, Bobby, and Cindy. With six children, Mr. and Mrs. Brady are concerned about treating everyone fairly and do not want to exclude Marcia and Peter from this transaction. But, at the same time, Mr. and Mrs. Brady do not feel that Marcia and Peter would participate in or appreciate an ownership interest in the business. In this situation, there are a variety of equalization techniques that Mr. and Mrs. Brady can implement to benefit Marcia and Peter without giving them an interest in Brady Architecture. For example, Mr. and Mrs. Brady could make an outright gift to Marcia and Peter of other assets they own, such as a vacation home or investment assets, or they could purchase a life insurance policy on one or both of their lives and name Marcia and Peter as the beneficiaries of this policy. Another example would be for Mr. and Mrs. Brady to provide more for Marcia and Peter under their estate plan than for the other children in order to account for the lifetime transfers of interests in Brady Architecture.

**Let's Keep It In The Family.** It is often important for families to keep business interests within the family as the business is transferred through generations. In choosing the best method to transfer business interests to apprentices, a creator may consider the potential for a future creditor attack against the next generation. In the Brady Architecture example above, what if, after Mr. and Mrs. Brady transferred business interests to Greg, Jan, Bobby, and Cindy, Jan was in a car accident and was sued by the other driver? Or Greg goes through a bitter divorce without the shield of a prenuptial

agreement? If each apprentice owns his or her interests in Brady Architecture outright, then, generally, the apprentice's interests in Brady Architecture would be reachable by the apprentice's creditor.

One way to limit a creditor's access to an apprentice's business interests would be for the creator to transfer each apprentice's business interests into a trust for the apprentice's benefit, rather than to each apprentice outright. The trustee of the trust controls the apprentice's business interests, and the apprentice receives distributions of trust property, including income, at the trustee's discretion (in the case of a fully discretionary trust), or at staggered ages of distribution, or in another manner prescribed by the terms of the trust. The apprentice could serve as a co-trustee of the trust and participate in business decisions, but an independent co-trustee would control distributions to the apprentice. In general, an apprentice's creditor could force a distribution from the trust only to the extent that the apprentice has access to the trust property.

If the transfer to a trust does not appeal to a creator, then another way to protect business interests from creditors is to restrict the transferability of such interests. These restrictions must be reasonable, such as a right of first refusal or the requirement for all shareholders to consent to the transfer, and are typically included in the business entity's governing documents, such as an entity's articles of organization, an LLC operating agreement, a corporation's bylaws, or a separate shareholder agreement.

Even with reasonable transfer restrictions, one thing to keep in mind is that different types of business entities afford different levels of asset protection. Please go to "Publications" on our website and read the November 2009 Bove & Langa Report for more details.

**Death, Disability, Retirement – Oh My!** After the business interests are transferred, the apprentices should enter into a buy-sell agreement, which would take effect upon the occurrence of a triggering event, such as death, disability, or retirement. For example, if Greg, Jan, Bobby, and Cindy each have a 25% interest in Brady Architecture and Cindy dies, what will happen to Cindy's interest? If it is transferred to her spouse and children under Cindy's own estate plan, what would her family's role be in the operation of Brady Architecture? Furthermore, if Cindy's interest in Brady Architecture is the main asset in her estate, how would her family have liquidity to pay any estate taxes due upon her death? If the Brady apprentices executed a buy-sell agreement when they first received their interests in the business, then upon Cindy's death, the terms of such an agreement would kick in and provide a solution to these contingencies.

There are three main types of buy-sell agreements that the family could implement. In continuing the example above, one type of buy-sell agreement, a cross-purchase agreement, would allow Greg, Jan, and Bobby to purchase Cindy's interests from Cindy's estate. A second type of buy-sell agreement, a redemption agreement, would allow Brady Architecture to redeem Cindy's interest. The third type is a combination of the two types discussed above and would give Brady Architecture the right to redeem Cindy's interest, but if Brady Architecture does not exercise that right in full, then Greg, Jan, and Bobby would have the right purchase all or the balance of Cindy's interest. This hybrid agreement allows for flexibility, giving the entity and its owners the opportunity to "wait and see" which method of purchase would be most practical under the circumstances at the time of purchase.

With any type of buy-sell agreement, at the time the agreement is executed, it is important that the business owners set a fair pricing method and also determine the way in which a purchase will be funded. With respect to funding, an individual business owner can always use personal assets to fund the purchase. However, the most common method used for funding the purchase is through insurance on the life of the individual whose interest is being purchased. For example, with a cross-purchase agreement, each business owner will purchase life insurance on the other owners' lives. With a redemption agreement, the entity will purchase the insurance policy (or policies) on its owners' lives. In choosing insurance policies to purchase, the owners must consider which type of insurance best fits their needs. A term insurance policy may work if the triggering event is death, but in choosing a term policy the owners must consider if the need for the insurance will exceed the term. On the other hand, if the triggering event is the disability or retirement of an owner, a cash-value type of insurance policy would be better in case the continuing owner needs to cash out the policy to purchase the disabled or retired owner's interest. Also, obtaining disability buy-out insurance policies on each business owner may be useful in the event of disability as well.

## The Boat Can't Go Forward If Each One Is Rowing Their Own Way:

There is much truth in this African proverb, and it speaks to the need to begin to address family business governance issues as soon as possible after the first generation decides its goal is to develop the family business to serve as a family legacy, rather than to develop the business for an eventual sale on the market (the proverbial "liquidity event"). There are many very good books devoted to this issue, and we'd be happy to point you in the right direction if you are interested. Here are some of the important concepts:

- *Generation Gestation*: It is rare for every person in the second generation to work in the family business, but the importance of every person buying in to the ultimate goal of business continuation is vital. Many writers speak to the value of the first generation passing on the story of the business, the hard work, the rewards, the sacrifices. The business becomes part of the family story for each individual, whether ultimately employed in the business or not.

- *A Baker's Dozen of Cousins*: We've all heard how hard it is for the family business to survive the third generation. Two sisters start a business, each has three children, each child has two children -- two become twelve before you know it. It may be true that it "takes two wings to fly", but the exponential growth at the cousins' level can often lead to a crash. It is important for a business to have a leader, but all of the third generation can be meaningfully involved in many ways. Writers suggest a family council that does not have business authority, but to which the family business leaders account on an annual basis, such as at a family retreat. Others suggest forming a family charitable foundation funded with a portion of the business profits and run by the cousins not employed in the business, which can solidify the business as a multi-family goal that all cousins can support and see its value.

- *The Expertise of Trustees*: The goal of the first generation family business leaders is to find and develop the leaders of the second and, possibly, third generation. But often the skill set that produced a profitable enterprise in not conducive to leadership development. Writers point to the value of finding outside experts to assist in the process, and one way to bring knowledgeable

outsiders into the succession process is by owning the business in a trust managed by a consortium of trustees consisting of family and insider key employees, but with the family ultimately in control of who serves as trustee and for how long. If the business is a corporation, a traditional "voting trust" can be used to combine the voting power of all the generational shareholders in one entity, with the voting trust managed by family and independent trustees. A relatively new idea is the use of a "private trust company" which is owned and managed by the family and can serve as a trustee of the voting trust, or of a trust that owns the business itself. It is the rare family business that over the generations can exist and grow without important input from non-family members, and a good succession plan anticipates this need in advance.

## FAST FACTS

It has been estimated that nearly 40% of family businesses in the United States will be passing the torch to the next generation within the next five years.

## SUMMARY

We hope you have found the Bove & Langa Report informative. We continuously seek to include material that is useful and profitable for you, and perhaps even a little entertaining. We always welcome your comments.