New and Enduring Problems in Business Succession Planning

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By:

Charles A. Redd

CHARLES A. REDD, PARTNER
STINSON LLP
7700 FORSYTH BOULEVARD
SUITE 1100
ST. LOUIS, MISSOURI 63105-1821
(314) 259-4534 - TELEPHONE
(314) 259-3952 - FACSIMILE
charles.redd@stinson.com

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CHARLES A. REDD

CHARLES A. REDD is a partner in the St. Louis, Missouri, office of the law firm of STINSON LLP. Mr. Redd concentrates his practice in estate planning, estate and trust administration and estate and trust-related litigation. Prior to joining Stinson, Mr. Redd was a partner in and Vice Chairman of the Trusts & Estates Practice Group at the law firm of SNR Denton US LLP (now Dentons US LLP). Mr. Redd was also previously a partner in the law firm of Armstrong, Teasdale, Schlafly & Davis (now Armstrong Teasdale LLP) and was Chairman of that firm's Trusts & Estates Department. He was previously employed as a Trust Administrator by First Wisconsin Trust Company (now U.S. Bank, N.A.), Milwaukee, Wisconsin, and as an Assistant Counsel by Centerre Trust Company of St. Louis (now Bank of America Private Wealth Management).

Mr. Redd has extensive experience and expertise in: (a) the drafting of wills, trust instruments, durable powers of attorney, marital agreements and other estate planning documents; (b) pre- and post-death tax planning for individuals, trusts and estates; (c) preparation and filing of estate tax returns, gift tax returns and fiduciary income tax returns; (d) representation and filing of estate tax returns, gift tax returns and fiduciary income tax returns; (e) representation of individual and corporate fiduciaries and (f) litigation in the Probate Division and other equity divisions of the Circuit Court. Mr. Redd has worked on estates and estate planning projects, some involving assets valued at over a billion dollars, and has successfully handled numerous estate tax, gift tax and generation-skipping transfer tax matters, will and trust construction cases, will contests, contests of trust agreements, alleged breach of fiduciary duty cases and other types of cases involving estates and trusts.

Mr. Redd is a member of the State Bar of Wisconsin, The Missouri Bar, the Illinois State Bar Association, The Bar Association of Metropolitan St. Louis and the Estate Planning Council of St. Louis.

Mr. Redd was Chairman of the Missouri Bar's Health Care Durable Power of Attorney Subcommittee, and he played a significant role in the drafting and enactment of the Missouri Durable Power of Attorney for Health Care Act. In 1991, Mr. Redd received The Missouri Bar President's Award. Mr. Redd was the principal draftsman of the recently enacted Missouri Family Trust Company Act.

Mr. Redd is an elected member of The American Law Institute and a Fellow of The American College of Trust and Estate Counsel (Past Missouri State Chair; Past Regent; Communications Committee (Past Chair); Estate and Gift Tax Committee; and Fiduciary Litigation Committee). He was an adjunct professor of law (Estate Planning) at Northwestern University School of Law for fifteen years. He serves as Co-Chair of the Editorial Advisory Board of, and writes a regular column in, TRUSTS & ESTATES magazine. In 2018, he was inducted into the Estate Planning Hall of Fame® by the National Association of Estate Planners and Councils. Mr. Redd is listed in The Best Lawyers in America and is "Band 1" ranked by Chambers and Partners in their High Net Worth guide. He frequently writes and lectures nationally on topics in the trusts and estates field.

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By: Charles A. Redd
Stinson LLP
St. Louis, Missouri

I. The Income Tax Deduction for Qualified Business Income

1. Introduction

The 2017 Tax Act enacted new Internal Revenue Code ("IRC") § 199A, which, in general, creates a deduction for the combined qualified business income received from certain pass-through and disregarded entities**.** This Section does not apply to taxable years beginning after 2025. IRC § 199A(i).

On August 8, 2018, the IRS issued proposed regulations under IRC § 199A. REG-107892-18, 83 Fed. Reg. 40884 (August 16, 2018). These regulations were finalized on January 18, 2019 and became effective after corrections on February 8, 2019. T.D. 9847. With the final regulations, the IRS issued new proposed regulations to provide guidance regarding previously suspended losses, regulated investment companies, charitable remainder trusts and split-interest trusts. REG-134652-18, 84 Fed. Reg. 3015 (February 8, 2019) (the "Newly Proposed Regulations").

For individuals, the deduction is available whether the individual claims the standard deduction or itemizes deductions. IRC § 63(b); Joint Explanatory Statement of the Committee of Conference on H.R. 1, 115th Cong. 1st Sess, p. 39 (2017). The deduction does not affect the calculation of adjusted gross income. IRC § 62(a); Akers, "Section 199A – Qualified Business Income Deduction Including Highlights of Final and Newly Proposed Regulations," at http://www.bessemer.com (February 2019).

The deduction is available for individuals, partnerships, S corporations, estates, trusts and any other taxpayer other than a C corporation. IRC § 199A(a). The deduction is applied at the pass-through owner level. IRC § 199A(f)(1); Treas. Reg. § 1.199A-1(e)(1); -6. The deduction does not affect the adjusted basis of a partner's interest in a partnership, the adjusted basis of a shareholder's stock in an S corporation or an S Corporation's accumulated adjustments account. Treas. Reg. § 1.199A-1(e)(1). The deduction is available for up to 20% of the taxpayer's taxable income (without consideration of IRC § 199A) minus the taxpayer's net capital gains (IRC § 1(h)). Net capital gain is defined as net capital gain under IRC § 1221(11) and includes qualified dividend income. Treas. Reg. § 1.199A(b)(3). The deduction cannot exceed the combined qualified business income of the taxpayer. IRC § 199A(a), (e)(1).

The deduction is for income tax purposes only. It is not available to reduce self-employment tax under IRC § 1402 or net investment income tax under IRC § 1411. IRC § 199A(f)(3); Treas. Reg. § 1.199A-1(e)(3).

2. Qualified Business Income

In general, qualified business income ("QBI") means the "deductible amount," determined under IRC § 199A(b)(2), for each qualified trade or business carried on by the taxpayer, plus 20% of qualified REIT dividends and qualified publicly traded partnership ("PTP") income. IRC § 199A(b)(1), (c); Treas. Reg. § 1.199A-1(b)(5), -3(b).

The deductible amount is the lesser of: (a) 20% of the taxpayer's QBI with respect to the qualified trade or business (defined below); or (b) the greater of 50% of the W-2 wages with respect to the qualified trade or business, or the sum of 25% of the W-2 wages with respect to the qualified trade or business plus 2.5% of the unadjusted basis immediately after acquisition of all qualified property ("UBIA") ((b) is hereinafter referred to as the "Wage/UBIA Test"). IRC § 199A(b)(2); Treas. Reg. § 1.199A-1(d)(2)(iv). The Wage/UBIA Test is applied only if taxable income exceeds the threshold amount, discussed below. IRC § 199A(b)(3)(A); Treas. Reg. § 1.199A-1(c).

Generally, QBI consists of net income from an active trade or business within the United States, less qualified REIT dividends or qualified PTP income. It does not include, among other items, capital gains, dividends, non-business interest, wage income received as an employee, any guaranteed payment described in IRC § 707(c) or payments to a partner for acting in a capacity other than a partner under IRC § 707(a). IRC § 199A(c); Treas. Reg. § 1.199A-3(b).

3. Qualified Trade or Business; Specified Service Trade or Business; Trade or Business of Being an Employee

A qualified trade or business is a trade or business other than: (a) a specified service trade or business ("SSTB"); or (b) the trade or business of being an employee. IRC § 199A(d)(1).

In general, a "trade or business" is defined in accordance with the provisions of IRC § 162(a). Treas. Reg. § 1.199A-1(b)(14). The IRS issued a proposed revenue procedure, Notice 2019-07, 2019-09 I.R.B. 740 (January 18, 2019), to provide a safe harbor permitting a rental real estate enterprise to be treated as a trade or business. A trade or business conducted by a disregarded entity will be treated as conducted by the owner of that entity. Treas. Reg. § 1.199A-1(e)(2).

The exclusion for a SSTB applies only if the taxpayer's taxable income is above the threshold amount, discussed below. These trades or businesses include those in the fields of law, health, accounting, financial services, actuarial science, performing arts, consulting, athletics, brokerage services, investment management or any business where the principal asset is the reputation or skill of one or more of its employees. Notwithstanding this provision, trades or businesses in the fields of engineering and architecture are considered qualified trades or businesses. Treas. Reg. § 1.199A-5(b).

If the trade or business is a SSTB and taxable income exceeds the phase-in range above the threshold amount, discussed below, none of the QBI, wages or UBIA for purposes of the Wage/UBIA Test will be taken into account in determining the taxpayer's QBI, even if the item is derived from an activity that is not itself a SSTB. IRC § 199A(d)(2); Treas. Reg. § 1.199A-5(a).

The regulations provide that a trade or business is not considered a SSTB if it has gross receipts of $25 million or less per taxable year and less than 10% of such gross receipts is attributable to the performance of services in a SSTB. If gross receipts are greater than $25 million in a taxable year, the trade or business still would not be a SSTB if less than 5% of the gross receipts are attributable to the performance of services of a SSTB. Treas. Reg. § 1.199A-5(c)(1).

The regulations contain anti-abuse rules related to SSTBs. A trade or business, or the portion of a trade or business, that provides property or services to a SSTB also is considered a SSTB if there is 50% or more common ownership with the SSTB receiving such property or services. These rules are intended to prevent the division of a SSTB into a SSTB and a non-SSTB for the purpose of increasing the IRC § 199A deduction. Treas. Reg. § 1.199A-5(c)(2).

4. Taxpayer With Taxable Income Above Threshold Amount

The threshold amount for 2019 is $160,700 of taxable income, or $321,400 of taxable income for a taxpayer filing a joint return. Rev. Proc. 2018-57, 2018-49 I.R.B. 827 (December 3, 2018). This threshold is indexed for inflation. IRC § 199A(e)(2).

If a taxpayer's taxable income is above the threshold amount, and the Wage/UBIA Test results in an amount that is less than 20% of the QBI, then the deductible amount determined under IRC § 199A(b)(2), discussed above, is reduced by a formula based on the taxable income in excess of the threshold amount. For 2019, if taxable income exceeds $210,700 ($421,400 for a taxpayer filing a joint return) the deduction under IRC § 199A is unavailable. IRC § 199A(b)(3); Treas. Reg. § 1.199A-1(d)(2)(iv).

There is a second limitation based on the threshold amount that applies to a SSTB, defined above. If taxable income exceeds the threshold amount, only a certain percentage of items of income, gain, deduction or loss, and the W-2 wages and UBIA shall be used in determining the deductible amount, defined above. The percentage is determined by a formula that reduces the percentage based on the amount by which taxable income exceeds the threshold amount. Once taxable income exceeds the threshold amount by $50,000 ($100,000 for taxpayer filing a joint return), the deduction is unavailable for the taxpayer's interest in the SSTB. IRC § 199A(d)(3). The taxpayer's interest in a SSTB may be subject to both the phase-out under IRC § 199A(b)(3) and (d)(3). Treas. Reg. § 1.199A-1(d)(4)(vi), Ex. 6.

For wages to be taken into account, the wages must be properly allocable to QBI of one or more trades or businesses. IRC § 199A(b)(4); Treas. Reg. § 1.199A-2(b). The IRS has issued a revenue procedure, Rev. Proc. 2019-11, 2019-09 I.R.B. 742 (January 18, 2019), which provides three methods for calculating W-2 wages.

5. Aggregation

The regulations provide rules allowing a taxpayer with interests in related trades or businesses to combine their QBI, W-2 wages and UBIA for purposes of applying the Wages/UBIA Test. Aggregation is permitted, but not required. In general, the regulations provide that aggregation is permitted if the trades or businesses are under common control, integrated and provide similar products or services. The regulations provide family attribution rules for determining control. Aggregation is disallowed for SSTBs except as provided above pursuant to Treas. Reg. § 1.199A-5. Treas. Reg. § 1.199A-4.

6. Multiple Owners or Beneficiaries

For entities with multiple owners, each owner is allocated the owner's allocable share of income, losses, basis and other items necessary to calculate the owner's QBI deduction. IRC § 199A(f)(1); Treas. Reg. § 1.199A-6. With respect to a non-grantor trust or estate with multiple beneficiaries, each beneficiary's portion of the trust or estate's QBI, W-2 wages and UBIA is based on the proportion of such beneficiary's portion of distributable net income ("DNI"), with any undistributed DNI used to determine the trust or estate's QBI, W-2 wages and UBIA. Whether a trust or estate exceeds the threshold amount is determined after considering any distribution deduction. Treas. Reg. § 1.199A-6(d).

The regulations also provide that a trust formed with a principal purpose of avoiding, or of using more than one, threshold amount under IRC § 199A will not be respected as a separate trust entity for purposes of determining the threshold amount. Treas. Reg. § 1.199A-6(d)(3)(vii).

The Newly Proposed Regulations provide that separate shares of a trust would be treated as a single trust for purposes of determining whether the taxable income of the trust exceeds the threshold amount. Prop. Reg. § 1.199A-6(d)(3)(iii).

7. Regulations Under IRC § 643(f)

IRC § 643(f) provides that, for purposes of subchapter J of the Internal Revenue Code (IRC §§ 641-692), pursuant to regulations, two or more trusts shall be treated as one trust if: (a) such trusts have substantially the same grantor or grantors and substantially the same primary beneficiary or beneficiaries; and (b) a principal purpose of such trust is the avoidance of the income tax. For purposes of IRC § 643(f), spouses shall be treated as one person.

The regulations include provisions that implement the rule under IRC § 643(f) by preventing taxpayers from dividing trust assets among multiple trusts so that each trust has income below the threshold amount. Treas. Reg. § 1.643(f)-1.

8. Effective Date of the Final and Newly Proposed Regulations

Most of the regulations apply to taxable years ending after February 8, 2019. *See, e.g.*, Treas. Reg. § 1.199A-1(f)(1). The anti-abuse provisions of the regulations, however, apply retroactively to taxable years ending after December 22, 2017, the date of enactment of the 2017 Tax Act (Pub. L. No. 115-97). *See, e.g.*, Treas. Reg. § 1.199A-5(e)(1). The regulations under IRC § 643(f) apply to taxable years ending after August 16, 2018, the date of publication of the Proposed Regulations in the Federal Register. Treas. Reg. § 1.643(f)-1(b). The Newly Proposed Regulations would apply to taxable years ending after the date the final regulations are published in the Federal Register, but taxpayers may rely on the Newly Proposed Regulations before that date.

II. Securing Retirement Income For The Business Owner

Frequently, one of the issues most important to the owner of a closely-held business in developing a succession plan is the need for income once he or she has passed control and/or ownership of the business to the next generation. Often, the client's current income depends heavily on a salary, bonuses, dividends or distributions from the business. The client's business interests represent the great bulk of his or her wealth, so that the client has few or no liquid assets, such as bank or brokerage accounts or retirement plans, that can be used to replace that income once the client is no longer active in the business. Leibell, "Taking a Little Off The Table," TRUSTS & ESTATES (May 2011).

Several techniques are available to replace the client's salary, dividends and other "control-assured" payments from the business with "contract-assured" payments from the business. Leibell, *supra*, *citing* Allen, "Representing the Patriarch in Family Business Succession," ALI-ABA Course of Study Materials, Estate Planning for the Business Owner (July 2006).

1. Sale To Grantor Trust and Sale For Private Annuity

These techniques for transfer of a family-owned business generate a stream of contract-based income for the client that can be used as retirement income.

a. ***<u>Sale To Grantor Trust</u>.*** Business owners frequently choose to transfer their business interests to successive generations via sale, with the business owner receiving an installment note as payment. If the sale is made to a trust that is a grantor trust as to the business owner, that is, a trust of which the client is treated as the owner for income tax purposes, then the sale transaction typically will not generate capital gains tax. The terms of the note must be commercially reasonable to avoid transfer tax consequences but otherwise can be structured to take the client's future cash flow needs into account. If the note is not paid off before the business owner's death, the outstanding balance will be included in his or her estate.

b. ***Sale in Exchange For Private Annuity***. Alternatively, a client may sell his or her business interests to the next generation in exchange for a private annuity, consisting of periodic payments to the client for life (or the shorter of life or a term of years). Unlike the sale to grantor trust technique discussed above, a sale for a private annuity can provide a source of income that can be extended for the client's life. The sale for a private annuity technique is best suited for the transfer of business interests that produce significant income. However, a sale for a private annuity is frequently inappropriate if the business is a C corporation because it can result in the double taxation of corporate dividends.

Typically, an owner's lifetime sale of his or her closely-held business "freezes" the business' value, for estate tax purposes, in that it removes from the owner's taxable estate future increases in the business' value following the sale. However, if the business is sold for a private annuity, then, all other factors being equal, to the extent that the aggregate value of the annuity payments paid over the client's life exceeds the value of the business, the benefit of this "freeze" is lost. Grassi, Jr., "Estate Planning for the Closely Held Business After the Pension Protection Act of 2006," 32 TAX MGMT. ESTATES, GIFTS AND TRUSTS J. 87 (Mar./Apr. 2007).

Proposed regulations issued in 2006 would dramatically change the tax consequences of these transactions. These proposed rules would provide that, if an annuity contract is received in exchange for property (other than money): (i) the amount realized attributable to the annuity contract is the fair market value (as determined under IRC § 7520) of the annuity contract at the time of the exchange; (ii) the entire amount of the gain or loss, if any, is recognized at the time of the exchange, regardless of the taxpayer's method of accounting, and taxed at capital gain rates; and (iii) for purposes of determining the initial investment in the annuity contract under IRC § 72(c)(1), the aggregate amount of premiums or other consideration paid for the annuity contract equals the amount realized attributable to the annuity contract (*i.e.*, the fair market value of the annuity contract). REG 141901-05; 71 Fed. Reg. 61441 (2006).

2. Non-Qualified Deferred Compensation

A non-qualified deferred compensation plan is a contract that binds the business owner to work for the closely-held business for a specified length of time – until a particular retirement age, for example – in exchange for a series of payments that the business will make upon the business owner's retirement (or death or disability). The plan can be structured so that payments are recognized as income to the recipient and deductible to the business only as they are paid. The payments are typically made in monthly installments for a pre-determined number of years, and the value of the payments can be fixed from the outset or can be tied to some other factor, such as the business' value or the amount of the salary payments made during employment.

Gianmarco & Grassi, Jr., "Practical Succession Planning for the Family-Owned Business," 33 TAX MGMT. ESTATES, GIFTS AND TRUSTS J. 140 (May/June 2008), and Jansen, "Closely-Held Company Deferred Compensation (and Alternatives)," 42 HECKERLING INSTITUTE ON ESTATE PLANNING Ch. 5 (2008).

3. Dividend/Distribution Policy

Another potential source of retirement income for the business owner is a dividend or distribution policy that the business owner puts in place before relinquishing a controlling interest in the company. Such a policy would require the business to make mandatory distributions to its owners, with the amount of the distributions often determined by a formula tied to the earnings of the business. These policies are common for businesses that are flow-through entities for income tax purposes, such as S corporations, as they ensure that the owners have sufficient liquid assets to pay the income taxes of the business that are taxable to them, and they can be designed so that the policy can be changed or undone only by a supermajority or even unanimous vote. These policies work best, of course, if the business owner is both planning to retain some (noncontrolling) ownership interest in the business and confident that the next generation of ownership and management will be friendly (or at least diversified) enough to continue the policy following the change of control.

4. Long-Term Leases

One income source that can be particularly attractive to the business owner who plans to divest him or herself of all interests in the business at some point is for the owner to enter into a long-term lease arrangement, in which the business pays the former owner rent for the owner's real estate or personal property, such as equipment. The rent payments could be fixed or increasing (or decreasing). This technique can also be attractive in the situations where the client anticipates that the business will eventually be sold to a third party, as the rental contract would remain a legally binding obligation.

5. Consulting Agreements

Another "contract-based" source of income to the business owner following a change of control, and possibly even the owner's retirement from the business, is to provide consulting services to the business as an independent contractor. This option, like the long-term lease arrangement described above, does not require the client to retain any kind of ownership interest in the business. The new business owners may find it an effective way to continue to benefit from the original owner's experience and knowledge. The client's consulting income in this situation would be subject to self-employment taxes.

III. Use of Trusts in the Disposition of Closely-Held Business Interests

1. Allocation of Business Interests Among Trusts

Following the death of the business owner, the Trustee of his or her formerly revocable trust will allocate the business interests held in the trust between or among the continuing trusts to be created under the trust instrument. To the extent not contrary to specific governing instrument provisions, the Trustee, in allocating business interests between or among continuing trusts, should consider:

- Who are the beneficiaries of the continuing trusts (and, in particular, whether any beneficiaries are active participants in the business);
- Who are the Trustees of the continuing trusts (and, in particular, whether any such Trustees are active participants in the business);
- What are the purposes and dispositive provisions of the continuing trusts;
- What are the prospects for growth in value of, or production of cash dividends or distributions by, the interests; and
- What is the known or anticipated tax posture of each of the continuing trusts?

In designing provisions allocating the interests in the family business among continuing trusts, the business owner and the estate planner should consider the above-listed factors and, in addition, whether a direction that such interests should be allocated to particular trusts should supersede, or be superseded by, a general direction to allocate all property among the business owner's then living descendants, *per stirpes*.

2. Dispositive Provisions of Continuing Trusts

The dispositive provisions of the continuing trusts to be created under the trust instrument after the death of the business owner to which business interests will or may be allocated should be structured, to the extent possible, in a manner that will be conducive to the trust's holding such interests. Except in connection with a trust intended to qualify for the estate tax marital deduction, a mandatory income or unitrust amount distribution provision may not be suitable. It may be wise to include broad and flexible discretionary principal distribution provisions that would enable discretionary distributions of business interests in circumstances determined by a capable Trustee. Powers of withdrawal over business interests, depending on the business owner's desires, may also be considered.

Similar considerations should be evaluated in designing powers of appointment. If a power of appointment is to be conferred on a beneficiary, depending on the circumstances, it may be desirable to allow the donee to appoint, or expressly to prohibit the donee from appointing, any family business interests. If a given power of appointment is to allow closely-held business interests to be appointed, of course, the class of permissible appointees of such interests can be as broad or as narrow as the business owner wishes.

Business owners may also implement transfer restrictions on business interests that dictate whether and under what circumstances current and future business owners may transfer interests in trust for a surviving spouse or other beneficiaries, including provisions describing the extent of a trust beneficiary's right to distributions of the business interests and who can serve as

Trustee. Mezzullo, "Cain v. Abel: Dealing With Sibling and Cousin Rivalries," 49TH ANNUAL HECKERLING INSTITUTE ON ESTATE PLANNING (2015).

3. Selection of Trustees

In the absence of a special, overriding provision in the trust instrument conferring business interests voting power on a person who is not a Trustee or is a trust protector, the Trustees will be in control of the business interests held in trust and, if such interest constitutes a majority interest, will be in control of the business itself. Further, depending on the trust's dispositive provisions, the Trustee may have the responsibility for deciding to what extent, if at all, any family business interests are distributed to beneficiaries.

In structuring the succession of Trustees for each trust in the business owner's estate plan, the following factors should be considered: (a) the age and maturity of the proposed Trustee; (b) the extent of the proposed Trustee's abilities generally in handling financial matters; (c) the current and/or expected future involvement, if any, of the proposed Trustee as an active participant in the operations of the business; and (d) the identity of the beneficiary or beneficiaries of the particular trust. Of course, the selected Trustee must possess the expertise and the temperament effectively to address the demands of the insiders and outsiders who have competing interests. *See* Gabbard, "Fiduciary Factors for Drafting Trusts With Closely Held Stock," ESTATE PLANNING, March 2015.

The potential conflicts of interest that may arise during the administration of a closely-held business interest is another factor that should be considered in selecting a Trustee. A Trustee, of course, must administer the trust in the best interests of the beneficiaries. If the Trustee holds a controlling interest in a closely-held business, the Trustee also must act in the best interests of the business and its other owners – who may or may not be the same as the trust beneficiaries. The will or trust instrument should include appropriate provisions exonerating the Trustee from conflict of interest claims. Manterfield & Devault, "Family Feud – Hollywood May Call it Entertainment But It Is No Laughing Matter for Family Businesses – Part II: The Advisor's Role in Business Succession Planning," 41 ESTATES, GIFTS AND TRUSTS JOURNAL 233 (2016).

Designating a young adult child of the business owner who is or is expected to be actively involved in the business as a Co-Trustee along with a corporate fiduciary can enable the child to ease his or her way into a primary decision-making role. In circumstances in which, say, only one child is an active participant in the business and a trust of which a non-actively involved child is the primary beneficiary would be funded with a portion of the business interest as well as other non-business assets, the trust instrument could designate the child who is the primary beneficiary of such trust as Trustee of such trust but designate the active participant child as the trust protector with sole authority to vote the family business interests. *See* Gabbard, *supra*.

A trust instrument should ordinarily contain provisions allowing Trustee removal and replacement. In addition to building into the removal and replacement provisions the customary safeguards, the business owner and the estate planner should also include language ensuring that, unless there is a material breach of fiduciary duty, the removal and replacement provisions cannot be used to wrest the power to control the business interests away from the person whom the business owner selected to have such control. Particular persons may be given the removal and replacement powers, and such powers may be made exercisable only under stated circumstances.

IV. Transferring Closely-Held Business Equity Among Family Members With Divergent or Conflicting Interests

1. The Typical Conflicts

Some of the most typical conflicts of interest surrounding a family-owned business are the conflicts that arise between family members who are active in the business' operation (the "insiders") and family members who do not work in the business (the "outsiders"). The outsiders may question the compensation and benefits received by the insiders, as well as their business decisions. The insiders may resent that their efforts are increasing the equity value of the business interest of the outsiders who, in turn, are demanding more return on their investment to which the insiders feel they are not justifiably entitled. *See* Berry, Jones and Redd, "Nothing Succeeds Like Successful Succession," 51ST ANNUAL HECKERLING INSTITUTE ON ESTATE PLANNING (2017).

In addition, conflicts frequently also develop among the insiders themselves; for example, they may disagree about business strategies or day-to-day management decisions. To complicate the situation further, a business owner's spouse, who may or may not be a parent of the affected children, may become involved in the decision-making, and maintaining family harmony may be more complicated. *See* Berry, Jones and Redd, *supra*.

2. Some Planning Alternatives

a. ***<u>Equal Distribution of Identical Business Interests</u>***. While the default plan often is to distribute the family business interests equally among all the children, this plan may not be advisable unless all the children get along well and are all insiders. For example, if the children own the stock of a family corporation equally, all have equal voting rights and there are more outsiders than insiders, the outsiders could set the dividend policy, which might not be conducive to growth and expansion of the business. The outsiders also could restrict the insiders' compensation and benefits so that the outsiders can receive a larger dividend (or, eventually, liquidation distributions). On the other hand, if there are more insiders than outsiders, the insiders could maximize their own salaries and benefits, and minimize dividends, to the detriment of the outsiders. Furthermore, if a child has been working in the business alongside the business owner for a considerable period, has foregone other career opportunities offering higher compensation to do so and has materially contributed to the success of the business, the business owner may want to give (and feel justified in giving) that child a disproportionately large share of the business interests. Perhaps, also, as a business management strategy, the business owner will want to consolidate ownership and/or control of the business in the hands of the insiders.

The decision of the Supreme Court of Pennsylvania in *Ferber v. American Lamp Corp*., 469 A.2d 1046 (Pa. 1983), provides an example of the risks of employing an equal distribution of the business interest in the business owner's estate planning documents. American Lamp Corporation (the "Corporation") was a closely-held family corporation owned by Benjamin Cohen. Annette Ferber, one of Mr. Cohen's daughters, was a minority shareholder and inactive in the business. Ms. Ferber's brothers (the "Brothers") acted as the corporation's officers and directors. Mr. Cohen's Will expressed Mr. Cohen's desire to have the Brothers be active in the business. The Will also stated that the profits, after distributing a portion to Mr. Cohen's surviving spouse, should be divided equally among Ms. Ferber and the Brothers.

The court explained that, from 1963-1979, each of the Brothers received $904,000 in total compensation from the Corporation (which included the use of corporate vehicles and boats for personal purposes), while Ms. Ferber received $13,553 as her share of the profits.

Ms. Ferber filed a claim demanding an accounting of the Corporation and payment of dividends. The claim also alleged that Ms. Ferber was entitled to a greater portion of Mr. Cohen's estate and that the Brothers had denied her that portion since Mr. Cohen's death. The trial court found for Ms. Ferber and determined her share of the profits that were not distributed to her to be $370,000 plus interest. The Supreme Court of Pennsylvania reversed but only with regard to proper calculation of damages.

b. ***<u>Allocating Control to Insiders</u>***. It is often appropriate to separate non-managerial interests in a family business (such as limited partnership interests or non-voting stock) from the management interests (such as general partnership interests and voting stock). The non-managerial interests may then be transferred to the outsiders. There may be disadvantages to this approach. For example, similar to the situation discussed above in which all children hold equal interests and there are more insiders than outsiders, the insiders with controlling interests may have an orientation towards retaining business earnings to fund future expansion, or perhaps increasing their compensation and benefits, rather than paying current dividends, which could work to the detriment of the outsiders. This problem might be addressed by adopting a dividend or distribution policy for the outsiders' interests or otherwise classifying the outsiders' interests as preferred. The business may also implement policies prohibiting excessive compensation. Mezzullo, *supra*.

c. ***<u>Distribution of Business Interests Only to Insiders and Distributing Other Assets to Outsiders</u>***. Alternatively, a business owner's estate plan can provide for insiders to receive business assets and for outsiders to receive non-business assets. This plan can be relatively easy to implement if the business owner has non-business assets sufficient to provide the outsiders with dispositions that the business owner deems fair. If this is not the case, it may be advisable for the business owner to buy life insurance that can be used to provide outsiders with non-business assets. Another variation of this technique is to provide that the business owner's estate will sell part or all of the business to the insiders, usually on favorable, preferred payment terms (*e.g.*, a long-term promissory note with low interest). Of course, the sale must be at fair market value to avoid creating unintended adverse tax consequences. *See* Berry, Jones and Redd, *supra*. The promissory note, rather than interests in the family business, can then be distributed to the outsiders. As long as a mutually agreeable purchase and sale price can be determined (or is set out in a buy-sell agreement), and as long as the insiders stay current in their note payments, this approach can be successful. Again, however, there would be continuing involvement by the outsiders, which may be good as a transition or may create further opportunities for conflict if there is doubt concerning whether the business can make all of the required payments.

d. ***Granting Outsiders Limited Decision-Making Powers***. Another approach is for the family members to adopt an agreement that gives the insiders some unilateral decision-making rights but requires one or more of the outsiders to join them for certain major decisions, such as dividend payments, acquisitions and significant capital expenditures. A problem with this approach is that the insiders could team with certain of the outsiders to the detriment of the others. Conversely, the outsiders could vote as a block on the major decisions and impede business growth.

One solution for this potential problem would be to have a designated number of non-family directors who would have the controlling vote if the insiders and outsiders could not agree on business issues. Non-family directors can be particularly helpful to the family, not only for the useful advice they might offer, but also for their ability to provide unbiased feedback on the quality of performance and the results accomplished. Non-family directors may also help ensure that the interests of those with nonvoting interests in the business are protected. A corporate Trustee may be able to fill this role, but corporate Trustees are sometimes reluctant to risk putting themselves in the middle of family business disputes. Lurie, "Coordinating Estate Planning and Business Succession," 41ST ANNUAL HECKERLING INSTITUTE ON ESTATE PLANNING (2007).

e. ***Puts and Calls***. Another option is to leave the business interests equally to all the children, with the interests owned by the outsiders subject to a "put," which is a mandatory redemption at a formula price or at an appraised purchase price paid over a period of time with a reasonable rate of interest so that the business would not have to expend a large amount of cash at one time. If the outsiders believe that the value represented by their interests in the business would be more productive if liquidated and placed into other investments, they can exercise their put rights and convert their investments.

The put allows the outsiders to remain as owners or have their interests redeemed at their election. Thus, if an outsider is involved in a conflict involving the business, the outsider can simply exit the conflict by exercising the put right.

To limit the risk that the business would have to redeem an interest at an outsider's election, the put rights could be structured so that they expire shortly after the business owner dies, thereby forcing the outsiders to make fairly prompt decisions about whether to remain as owners. Further to offset the advantage a put would provide for the outsiders, the insiders could have a "call" on the outsiders' interests, exercisable after the outsiders' put rights expire. A call would allow the insiders to elect to redeem the outsiders' interests.

f. ***Outsiders Who May Later Become Active in the Family Business***. What if one or more members of the next generation have not decided whether to enter the family business by the time the business owner wants to complete his or her transfer of control and ownership? One solution may be that the owner, the business and the undecided relative can enter into an agreement through which the relative can elect to become an employee or owner of the business on terms to be established subsequently by all the family members or by non-family directors with or without the family's participation. Similarly, the same group could allow the relative to acquire a business interest at a formula or appraisal price payable using an installment method over a reasonable period of time, which would allow the relative to use his or her earnings to pay for his or her business interest. Thus, the business owner would not have to rely on the insiders alone to make the decision and establish the terms under which an undecided relative could become an employee or owner of the family business.

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Fax (706) 353-3994, Email lfrye@CannonFinancial.com
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