TI TRUST
TRUE INTEGRITY FIDUCIARY SERVICES
estate planning studies®
www.ti-trust.com
Issue 1 2025

Business Succession Planning Part One: Introduction and Providing Liquid Strategies

By Louis A. Mezzullo

INTRODUCTION

Background

Business succession planning is planning for the orderly transfer of the management and the ownership of a business to new managers and new owners to avoid a liquidation of the business as well as unnecessary taxes and other expenses, and in a manner that carries out the family's nontax objectives. Note that the ownership of the business and the management of the business may go to different people. Management may even go to non-family members. Ownership may be transferred outside of the family.

Even if the federal estate tax were repealed, and even if the federal income tax were repealed, business succession planning would still be necessary. The estate tax is an additional, but significant, issue that must be addressed. Usually, the estate tax issue involves providing the funds to pay the estate taxes at the death of the founding entrepreneur (or, in the case of a married person, at the death of the survivor of the entrepreneur and his or her spouse if the unlimited marital deduction is being used). Some of the suggested strategies may involve transactions that are subject to income tax, such as intra-family sales not involving grantor trusts.

Business succession planning requires creativity, flexibility, and perseverance; understanding the company's financial situation; appreciation for the family's dynamics; familiarity with key employees and non-family equity owners; knowledge of the tax and nontax law, including corporate, partnership, limited liability company (LLC), and employee benefit law; and knowledge of the estate planning and administration issues.

Characteristics of the Family Business

A family business is an enterprise owned and controlled by one or more families who expect succeeding generations to own and manage it. Only about 30% of family businesses survive to the second generation, and 12% to the third generation. However, lost in the statistics may be family businesses that did not pass to the next generation because the family decided for good reasons that it was the better alternative.

Most businesses in the United States are closely held and create over 75% of all new jobs. Family businesses generate about half of our gross national product and are prominent in retailing, distribution, and services.

Surveys report that family business owners are more satisfied with the quality of their work lives than the general work force. The strengths of a family business are independence, a feeling of accomplishment, and money.

Some of the sources of tension in a family business include the fear of the crippling effects of estate taxes on the business; emotion and control issues, not disagreements based on facts; sibling rivalries; and the older generation's feeling that there is a right not to be forced to retire. In a family business, "retirement" in the owner's mind may mean keeping control but not having to worry about day-to-day matters.

Consultants advise dealing with the succession issue at least 10 years before retirement and putting new management in place at least 5 years before retirement, although planning should actually occur much sooner. Waiting too long makes customers, suppliers, and creditors nervous. Business succession planning frequently is 10% planning and 90% money. Consequently, if there isn't proper planning or lots of cash, the business may not survive the death of the founding entrepreneur.

Liquidity Needs of the Business Owner

For most family business owners, the business represents the most valuable, and often the most illiquid, asset in the owner's estate. During the business owner's lifetime, the business is generally the primary source of economic and emotional support for the business owner's family. As the primary asset of the owner's estate, the business will be the source of funds to pay estate taxes, debts, and administration expenses, as well as to pay for the support of the surviving spouse and other dependents. Without proper planning, the business may have to be sold to meet the liquidity needs of the family.

Issues Facing the Business Owner

The business owner planning to transfer the business to the next generation is confronted by many issues. Should the owner sell the business during the owner's lifetime? Should the business be continued after the owner's death? Who will control the business after the owner's death? Who will own the business after the owner's death? Who will manage the business after the owner retires or dies? Will the owner's children be treated equally in the distribution of the owner's estate?

The owner's objectives for the business must be consistent with the owner's estate plan. For example, if the owner wants the business to pass to one particular child, steps must be taken to provide for the other children and the payment of the estate taxes attributable to the business.

Goals of Owners of Businesses

- Retain control.
- Retain income to continue lifestyle of the owner and owner's spouse.
- Satisfy estate-planning objectives.

  For example, treating children equally or fairly.

  Perhaps making some provision for grandchildren and more remote descendants during the owner's lifetime or at the owner's death.
- Provide for the continuity of the business, which may be partly psychological.
- Concern for employees of the entity.

  Providing for "key" employees.

  Providing retirement income to all employees.

  Providing other fringe benefits to employees.

  Perhaps giving some employees an equity interest in the business.
- Concern for the community in which the business is located.

  Providing employment.

  Contributing to local civic, cultural, and charitable organizations.
- Charitable desires. See example below.
- Dynasty concerns.

  Ensuring the business will survive the next generation.

  This usually involves dealing with potential or real sibling rivalries.

The duration of any trust holding business interests will be limited by the applicable rule against perpetuities, if there is one in the applicable jurisdiction.

- Reduce transfer taxes.

  This may involve lifetime transfers to reduce the founding entrepreneur's interest to a minority interest, thereby reducing its value for estate tax purposes.

  However, what if the business is sold after a substantial portion has been transferred to children or more remote descendants?

  How does the founding entrepreneur retain control?

- Reduce income taxes.
- Reduce administration expenses.
- Provide for liquidity, including the payment of estate taxes.

Disposition of Business

Sale of assets. In the case of a C Corporation, a sale of assets, will involve two levels of tax, once to the corporation on the unrealized appreciation of its assets and once to the shareholders on the excess of the value of the liquidating distribution over their basis in the stock.

Sale of stock. It is usually difficult to find a buyer of the stock of a closely held corporation because of potential unknown liabilities. In addition, the purchaser may not want the existing basis for the corporation's assets, although there are ways to have the basis reflect the purchase price for the corporation.

Tax-free acquisition—merger. A tax-free exchange will usually require that a significant number of the family members receive stock in the acquiring company rather than cash and the stock will usually be subject to restrictions on resale for a period because of securities laws.

Tax-free division—split-up, split off, or spin off. These may be useful when there are sibling rivalries. A tax-free division could involve dividing the business geographically, by product line, or into retail and wholesale components.

Sale to employees. This may be an appropriate strategy when no family members are interested or capable of taking over the management of the business, and it is not practical to bifurcate the ownership and the management because the cash generated by the business does not enable the business to provide enough compensation to non-family members to entice them to assume major roles in running the business. The issue here is finding the necessary financing.

Give or sell to family members during lifetime. A sale will usually involve taxable gain. A sale may be a way to treat children equally when not all of them are active in the business. A taxable sale will avoid any gift tax, assuming it is for full and adequate consideration.

Sale to grantor trusts—family members as beneficiaries. See the example below. This technique avoids both income and gift taxes if structured properly.

Transfer equity interests to one or more grantor retained annuity trusts (GRATs). See the discussion of GRATs below.

Give or sell to family members at death. Allowing family members to purchase the ownership interest of a decedent at a pre-established price may have unintended transfer tax and nontax consequences because of I.R.C. § 2703, if the price is not equal to the fair market value of the interest as determined for federal estate tax purposes. It could affect qualifying for the marital deduction or the amount of the marital deduction. It could raise the issue as to who will pay the additional estate tax on the additional value. One way to deal with this issue is to have the purchasing family member pay the additional estate tax attributable to the increased value.

Liquidation of the business, including bankruptcy. The business succession plan has failed or one was never adopted or implemented. The forced liquidation or bankruptcy results in the loss of intangible value, including goodwill and going concern value.

Conclusion

Careful planning involving the entire family at an early stage, followed by implementation and follow-up, will significantly increase the chances for the successful transition of the business to the next generation.

EXIT STRATEGIES

Sale to a Grantor Trust Example

A grantor trust is a trust where the grantor of the trust (generally the person who contributed the assets to the trust) is treated as owning the assets for income tax purposes. I.R.C. §§ 671-679. Consequently, transactions between the grantor and the trust, including sales, are not recognized for income tax purposes. Rev. Rul. 85-13, 1985-1 C.B. 184. However, transfers to a properly structured trust are recognized for gift and estate tax purposes. Consequently, assets transferred to the trust will not be included in the grantor's estate for estate tax purposes. Transfers to the trust will not be taxable gifts if the grantor receives fair market value for the transferred asset. If the grantor takes back an installment note, there will not be a taxable gift as long as the principal is equal to the fair market value of the transferred asset and the interest rate charged is equal to the applicable federal rate.

Example:

Mr. Entrepreneur owns 100 shares of the stock of an S Corporation having a fair market value of $20,000,000. He also owns commercial real estate having a fair market value of $20,000,000. He has four children—two active in the business and two not active in the business. He wants to treat the children equally but does not want the children who are inactive in the business to have any ownership in the business.

To carry out his desires, Mr. Entrepreneur could do the following:

(1) Recapitalize the corporation to create 10 shares of voting stock and 90 shares of non-voting stock:

(2) Sell 90 shares of non-voting stock to grantor trusts having as beneficiaries the two children who are active in the business. Assuming a 50% combined discount for lack of control and marketability, the value of the stock sold to the trusts would be $9,000,000 (90% times $20,000,000 = $18,000,000 times 50% = $9,000,000).

(3) Transfer the commercial real estate to a Limited Liability Company (LLC) in exchange for a 90% non-voting membership interest and a 10% voting membership interest.

(4) Sell the 90% non-voting membership interest in the LLC to grantor trusts having as beneficiaries the other two children. Assuming a 50% combined discount for lack of control and marketability, the value of the LLC interests sold to the trusts would be $9,000,000 (90% times $20,000,000 = $18,000,000 times 50% = $9,000,000). To avoid a number of potential tax problems, Mr. Entrepreneur should contribute $1,000,000 to each of the trusts, using some of his gift tax applicable exclusion amount or using some of his and his wife's gift tax applicable exclusion amounts through a split-gift election.

(5) At his death or the death of the survivor of him and his wife, Mr. Entrepreneur would leave the voting stock in the corporation to the two children active in the business, and the remaining membership interests in the LLC to the other two children, or to trusts for the benefit of the children.

GRATs

In a GRAT, an older family member transfers an asset to a trust and retains the right to receive a fixed dollar amount for a period of time, after which the transferor's interest terminates and either the asset is distributed to the beneficiaries, usually younger family members, or the trust continues on for some period.

Under I.R.C. § 2702, the value of the gift is the value of the transferred asset less the value of the retained annuity interest, provided that requirements contained in I.R.C. § 2702 and the regulations thereunder are satisfied. The present value of the retained interest in a GRAT for transfer tax purposes is determined using the so-called 7520 rate, which is 120% of the federal mid-term rate. Consequently, if the value of the asset transferred to the GRAT does not increase in value by more than 120% of the federal mid-term rate, there is no tax-free shifting of value to the remainder beneficiaries of the trust.

If the transferor dies before the end of the annuity term, the assets in the GRAT will be included in the transferor's estate under I.R.C. § 2036(a), because he or she has retained the right to enjoy the income from the transferred assets, but only to the extent of the value of the assets necessary to provide the annuity payments. If the transferor's estate were entitled to continuing payments, the present value of those payments would be includable in the transferor's estate under I.R.C. § 2033.

The benefit of a GRAT is the potential shift of value to younger beneficiaries free of transfer tax. This objective may be accomplished with minimal gift tax liability if the value of the donor's retained annuity interest is close to the value of the asset transferred to the trust. Because the retained annuity interest in a GRAT may be valued as an annuity for a specified term of years, rather than as an annuity for the shorter of a term certain or the period ending upon the grantor's death, it is possible to fix the value of the donor's retained annuity interest at the same value as the value of the transferred asset (hence the zeroed-out GRAT), although many commentators suggest that there be at least a small gift element. *Walton v. Commissioner,* 115 T.C. No. 41 (2000). Treas. Reg. § 25.2702-3(e), example 5.

It is also possible to fix the value of the asset for gift tax purposes with relative certainty by tying the amount of the annuity payment to a percentage of the transferred asset's value as finally determined for gift tax purposes, because any increase in value on audit would cause a corresponding increase in the amount of the annuity payment, resulting in a very small increase in the value of the remainder interest, which is the measure of the gift.

Note that seed money, which many commentators suggest is necessary in the sale to a grantor trust technique, is not required. Finally, because the requirements of a GRAT are spelled out in the Code and the regulations, there is greater certainty that the desired tax consequences will be achieved.

There are some disadvantages of a GRAT. If the grantor dies during the term of the GRAT, the value of some or all of the assets in the GRAT will be includible in the grantor's estate. In addition, the value of the retained interest is based on 120% of the mid-term rate, which in most cases will be higher than the applicable federal rate used for determining the minimum interest to be paid on the installment note in the case of an installment sale to a grantor trust to avoid any taxable gift in connection with the sale.

Also, the grantor cannot allocate his or her GST tax exemption to the transfer of assets into a GRAT until his or her interest terminates. Finally, distributions from a GRAT may only be made to the holder of the annuity interest during the term of the interest, while in the case of an installment sale to a grantor trust there are no restrictions on who may receive distributions from the trust before or after the note has been satisfied, although the grantor should not be a beneficiary of the trust to avoid inclusion of the trust assets in the grantor's estate.

Example

The use of a GRAT may be beneficial if the value of the property transferred to the trust will increase at a rate in excess of the rate determined under I.R.C. § 7520. The transfer of a minority interest in an S corporation or a limited partnership interest to a GRAT may allow the annuity payment to be lower than the actual pro rata portion of the expected income attributable to the stock or partnership interest due to the minority discount that would apply to the value of the stock or partnership interest when transferred to the trust.

For example, assume the owner of an S corporation having a fair market value of $1,000,000 transfers 49% of the stock (which can be non-voting) to a trust, retaining the right to an annuity equal to 5.0% of the initial value of the assets of the trust, payable for 20 years. Assume that the appropriate interest rate for valuation purposes under I.R.C. § 7520 is 5.0% (the 7520 rate for December 2024). Assume also that the value of the minority interest held by the trust is $294,000, based on a 40% minority discount (60% times $490,000). The annual payment would be $14,700, which is 5.0% of the discounted value of the minority interest, but only 3.0% of the undiscounted value of the interest ($490,000). If the corporation increases in value (including retained earnings) at a rate greater than 3.0%, a shift in value to the remainder beneficiary will be achieved transfer-tax free. By contrast, if no minority discount were applicable to the interest held in trust, the corporation would have to increase in value at a rate greater than 5.0% to achieve a similar transfer-tax free shift in value. Thus, contributing property that is subject to a minority discount allows the grantor of the trust to leverage the benefits of a GRAT.

Note, however, that in PLR 9707027, involving the funding of a GRAT with cash, marketable securities, and certain limited partnership interests, the facts state that the value of any gifts of non-publicly traded partnership interests made to the GRAT will be determined without regard to any discounts for the grantor's lack of control. Presumably, the IRS required the grantor to agree to such a method of valuing the limited partnership interests.

Using Life Insurance to Provide Liquidity

Life insurance provides instant cash, usually on an income tax free basis, to pay estate taxes and other administration expenses and to buy out a deceased owner's interest. Once it is decided that life insurance has a role, the next concern is keeping the proceeds out of the insured's estate, if possible.

One way of excluding the insurance proceeds from either the insured's estate or the value of the company is to have the older generation establish grantor trusts for the benefit of members of the younger generations. The older generation family members would gift and sell equity interests to the trusts established for members of the younger generations, avoiding any income tax on the sale. The trusts for the members of the younger generations would purchase insurance on the lives of the members of the older generation sufficient to enable the trusts to purchase the equity interests owned by the older generation family members at the death of the survivor of the husband and wife.

Premiums could be paid out of the income from the equity interests distributed to the trusts. Note there would be no income tax incurred on either purchase; the original purchase by the grantor trust would be disregarded as a purchase by the grantor, and the purchase at the death of the older family member would presumably be at the fair market value of the equity interests, which would also be the basis of the equity interests under I.R.C.§ 1014.

The trust could be designed so that the assets in the trusts would not be included in the estate of the younger generation family members. In fact, if the trusts were established in a jurisdiction with no rule against perpetuities, the trusts could last indefinitely. Because the trusts could have a zero inclusion ratio, there would be no estate or generation-skipping transfer tax liability.

Using a CRUT to Reduce Tax Liability

A charitable remainder trust (CRT) benefits one or more non-charitable beneficiaries during the lifetime of the non-charitable beneficiaries or for a term of years. At the termination of the non-charitable beneficiary's interest, the CRT benefits a charity.

A CRT may be a charitable remainder annuity trust (CRAT) or a charitable remainder unitrust (CRUT). Under a CRAT, a specific sum of money, which must be at least five percent (and not more than 50 percent) of the initial net fair market value of the property donated to the trust, is distributed at least annually to a non-charitable beneficiary. For example, a CRAT to which $1,000,000 is contributed might provide that $50,000 per year is to be distributed to the donor during his or her lifetime. Upon the death of the donor, any assets remaining in trust are distributed to the selected charity. I.R.C. § 664(d)(1).

Under a CRUT, the non-charitable beneficiary does not receive a fixed payment each year. Instead, the non-charitable beneficiary receives a unitrust amount, which is calculated as a percentage (not less than five percent or more than 50 percent) of the net fair market value of the trust assets, as determined at least annually. For example, under a CRUT, the donor might be entitled to receive an amount equal to seven percent of the value of the trust assets, as determined on January 1 of each year. Any assets remaining in trust at the death of the donor will be distributed to the selected charity. I.R.C. § 664(d)(2).

The CRUT is the more flexible of the two types of CRTs for planning purposes. The creator of a CRUT may transfer additional assets to a CRUT at a later date. Additional contributions may not be made to a CRAT. Treas. Reg. § 1.664-2(b). Under either type of CRT, the principal of the trust may be invaded to make the necessary annuity or unitrust payments to the non-charitable beneficiary.

However, under a CRUT, it is possible to limit unitrust payments in any year to the amount of the income. Missed unitrust payments may be made up in later years when income is sufficient, up to the amount of unpaid unitrust amounts. The trust instrument must specifically require this distribution scheme; it may not leave the distribution of the income or unitrust amount to the discretion of the trustee. I.R.C. § 664(d)(3).

By establishing a CRUT in this fashion, a donor may invest assets for capital appreciation during the early years of the trust, while deferring payment of the unitrust amounts until later years. In this way, CRUTs may be used to provide retirement income.

A CRUT may also be established as a FLIP CRUT, which permits the CRUT to convert from an income-only CRUT to a traditional CRUT upon the happening of certain events—such as death, attainment of a certain age, the birth of a child, a marriage or divorce, or the sale of an unmarketable asset such as real estate or closely held or restricted stock—that are not within the discretion of the donor. Treas. Reg. § 664-3(a)(1)(i)(c).

A FLIP CRUT provides a number of planning possibilities, including providing for a surviving spouse, the education of a child, the possibility of a child's divorce or disability, and additional income at retirement. It also provides a better result when nonmarketable assets are transferred to a CRUT. Once the asset is sold, the trust can convert to a straight unitrust so that investments can be made for total return and without any concern for current yield. Appreciation after the contribution to the CRUT can be treated as income. Treas. Reg. § 1.664-3(a)(1)(i)(b)(3).

Example

Mrs. Entrepreneur, a widow age 72, owns all 1,000 issued shares of the voting common stock of Main Street Dress Company, which is a C Corporation. Her basis in the stock is $1,000,000. She has three adult children, none of whom are interested in running the business. She has been approached by several chain stores about buying the business.

In 2025, Mrs. Entrepreneur contributes the shares to a 5% FLIP income-only unitrust with a make-up provision and language authorizing realized gains from post-gift appreciation to be treated as trust income. The trust agreement also provides that when the shares are sold, the trust will convert to a standard unitrust. The trust agreement also makes an exception to the normal duty to diversify and specifically directs the trustee to retain the shares. She retains the unitrust interest, and names the State Foundation, which is a public charity, as the remainder beneficiary. At the time of the contribution, the value of the corporation was appraised at $10 million. To retain control, Mrs. Entrepreneur names herself as the initial trustee.

Mrs. Entrepreneur receives both an income and gift tax deduction for the value of the remainder interest. During the first three years of the trust, because the corporation pays no dividends, Mrs. Entrepreneur receives no distributions from the trust. In 2028, the shares are sold for $12 million. Although the value of the corporation was reappraised each year at the same $10,000,000, the buyer was willing to pay more than the appraised value because it was a "strategic buyer."

In 2028, Mrs. Entrepreneur is entitled to a distribution from the trust equal to $2 million (which is also the income of the trust for the year: i.e., the gain realized on the sale of the shares), which is the sum of the unpaid unitrust payments, $1,500,000 (3 years times 5% times $10 million) and $500,000, which is 5% of the $10 million trust asset value as of the valuation date for 2028.

The proceeds of the sale will be invested in a diversified portfolio. Beginning in 2029, Mrs. Entrepreneur will receive the 5% unitrust interest (5% of the value of the trust assets determined each year) without the income cap that applied before the sale of the shares. If Mrs. Entrepreneur wanted to pass an equivalent amount of value to her children, she could create an irrevocable life insurance trust and have the trust purchase a $10 million policy on her life, using the annual exclusion and perhaps part of her gift tax exemption to pay the premiums.

Louis A. Mezzullo is Of Counsel with the International Law Firm of Withers Bergman LLP. His areas of practice include estate planning, business succession planning, and planning for distributions from qualified benefit plans and IRAs. He has written 14 books and numerous articles on these subjects. He also serves as an expert witness in the areas of his practice, including malpractice cases. He is past president of the American College of Trust and Estate Counsel, past chair of the American College of Tax Counsel, and past chair of the American Bar Association Section of Real Property, Trust and Estate Law.

TI TRUST
Personal Trust and Farm Services

Email: mail@ti-trust.com

Web: www.ti-trust.com

Quincy, Illinois
2900 North 23rd Street
Quincy, IL 62305
Phone: (217) 228-8060

St. Peters, Missouri
4640 Mexico Road
St. Peters, MO 63376
Phone: (636) 939-2200

Oak Brook, Illinois
600 West 22nd Street
Suite 308
Oak Brook, IL 60523
Phone: (630) 986-0900