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Transferring the Family Business — Part IV: Not Just Gifting

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This is part four of a five part series.

Our last post covered certain gifting techniques. Today, we will look at some non-gift approaches to transferring a parent's interest in the family business to his or her children.

Sale

The most common means for transferring a business interest to someone is through a sale of the interest. Thus, it's not unusual for a parent to sell a business interest to a child. Indeed, a sale may comport with a parent's philosophy that a child should "earn" the interest. In addition, for a parent who needs a flow of funds in respect of the business interest, a sale presents an attractive option.

A sale is also an attractive option where the parent wants to shift the future appreciation in the value of the business interest out of his or her estate, but the parent's remaining gift tax exclusion amount is insufficient to cover the transfer. If a parent sells a business interest to his or her child, for consideration in an amount equal to the value of such interest at the time of the sale, no gift occurs. Moreover, the sale allows the parent to effectively "freeze" the value represented by the interest at its sale price – by exchanging the interest for non-appreciating cash and/or a promissory note – and to shift any future appreciation in the interest (above the sale price) to the child.

The sale could be for the full value of the business interest, or for a bargain price, i.e., an amount that is below the fair market value ("FMV") of the interest at the time of its sale. In the case of a bargain sale, or, in an instance in which the IRS successfully challenges the "full sale price" as too low, the excess of the FMV over the amount paid would likely be treated as a gift. In both instances, however, the increased gift tax exclusion amount (for tax years beginning after 2010) may provide a greater cushion for sales that are partially characterized as gifts.

The cost of a sale

Although a sale can be an effective tool for transferring a business interest to one's children, it will likely come with a cost: income tax. Where the interest sold was a capital asset (as is typically the case), the sale of which generates long-term capital gain, the lower 20 percent federal capital gains rate would apply to the amount recognized; the 3.8 percent surtax on net investment income may also apply.

In addition, once an interest is sold to a child, the child would then own the business interest outright, though his or her exercise of many "incidents of ownership" may be contractually restricted somewhat through the use of shareholder and operating agreements. Alternatively, the interest may be sold to an irrevocable trust of which the child is the only beneficiary – more on this later.

Installment sales

A sale may also be structured as an installment sale; i.e., in exchange for the child's promissory note. An installment sale may be appropriate where the parent wants to defer the gain recognition on the sale, or where the child is unable to make a lump sum payment for the business interest.

In order to avoid gift characterization of any portion of the sale transfer, the child's installment obligation should bear a statutorily prescribed minimum rate of interest, the installment obligation should be memorialized in writing (with a note and sale agreement), preferably secured (at least by the transferred property), the term of the note should not exceed the seller's life expectancy, and payments (both the amount and timing thereof) should be made as required by the terms of the sale and note agreements. Additionally, as always, the value of the business interest should be established with an appraisal. Principal may be payable currently or in a balloon at maturity; preferably, interest would be payable currently. Ideally, each of the parent and child should have separate counsel.

Of course, the sale is taxable to the taxpayer for income tax purposes, though gain in respect of the installment obligation is only recognized as principal payments are made; interest (actual or imputed) is taxable as ordinary income. If the parent should die before the note is satisfied, the value of the note as of the date of death will be included in his or her estate for estate tax purposes. Thus, the FMV of the note at that time (usually the unpaid principal if adequate interest was provided), plus the accrued but unpaid interest, may be subject to estate tax. Moreover, because it represents an item of "income in respect of a decedent," the note will not receive a basis step-up (unlike most items of property that are included in a decedent's gross estate), thus preserving the tax gain inherent in the note.


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SCIN

How does one address the inclusion of the note in the parent-seller's estate if the parent dies before the note has been satisfied?

In some cases, the parent will receive a "self-cancelling installment note" (SCIN) in exchange for the business interest being sold. In the case of a SCIN, the remaining note principal is cancelled if the parent dies before the end of the note term. Of course, this benefits the child-buyer, and it also avoids inclusion of the note in the parent's estate. This technique works best where the parent is not expected to survive for his or her life expectancy, but is not terminally ill.

Sale to Grantor Trust

While an installment sale may "freeze" the value of the parent-seller's business interest for estate tax purposes, there are some disadvantages to consider: the interest and principal that must be paid are taxable; if the seller disposes of the note (or if the child disposes of the purchased property within two years after its purchase), the gain on the sale is accelerated; a special interest charge may apply if the principal of the note exceeds $5 million, which defeats the deferral benefit of installment reporting (though an inter-spousal gift of a portion of the interest to be sold may alleviate this problem); and the sale of an LLC or partnership interest may result in immediate gain recognition (if the entity has any indebtedness).

There is another option that should be considered: a sale of the business interest to a grantor trust. In order to use this technique, an irrevocable trust must be created and funded. The trust is structured as a grantor trust so that the parent is treated as the owner of the trust for income tax purposes. In general, the funding requires a seed gift equal to at least 10 percent of the FMV of the business interest to be sold to the trust. Again, the increased gift tax exclusion amount allows a greater seed gift to be made on a tax-free basis, which allows more property to be purchased by the trust. The parent then sells business interests to the trust in exchange for a note with a face amount equal to the value of such assets, bearing a minimum rate of interest and secured by the property acquired. The interest may be payable annually, with a balloon payment at the end of the note term. The sale to the grantor trust is not subject to capital gains tax (since the parent-taxpayer is dealing with him- or herself), and the issuance of the note prevents any gift tax (since there is adequate consideration). (If the IRS does challenge the adequacy of the consideration, the shortfall will be treated as a gift, which the increased exclusion may protect.) The value of the business interest sold to the trust is frozen in the parent's hands in the form of the note, the cash flow from the interest and/or the appreciation in the value of the interest should cover the loan, and the remaining, excess value of the interest passes to the beneficiaries of the trust.

Price Adjustments

In the case of a sale, whether to a child or to a trust (grantor trust or otherwise), of closely held business interests, the IRS may challenge the transfer as a bargain sale; i.e., the sales price is below the FMV of the property being sold.

In order to address this possibility, taxpayers have sometimes included a valuation adjustment clause in the sale agreement. In general, the IRS has refused to recognize such clauses, claiming that

they violate public policy.

More recently, taxpayers have employed "formula clauses" that express the amount of the property being sold as a formula; e.g., "that number of shares having a value of $X as determined for gift tax purposes." To the extent that the value of the shares sold, as finally determined, exceeds the stated purchase price, the "excess" shares have usually been directed to a spousal trust or to a charity (but not back to the seller). However, one court has approved a defined value clause where the excess business interest was "returned" to the donor-taxpayer; the court held that what the taxpayer had transferred were units in a business having a specific dollar value, and not a specific number of units. Thus, the taxpayer was able to avoid a taxable gift in excess of the gift tax exclusion amount.

In the case of a parent who has completely exhausted his or her gift tax exclusion amount, but who still wants to transfer business interests to a child by way of a sale, the parent may want to consider a defined value clause to try to ensure that the amount sold to the child does not exceed the consideration received for the sale.

Family Limited Partnerships

The final transfer vehicle to consider is the family limited partnership, or FLP. A number of advisers tout FLPs as a great way to generate valuation discounts and, in fact, a properly structured FLP may generate significant transfer tax savings.

Notwithstanding the valuation benefit, the parent's adviser should not focus the parent-client primarily on the discounts. There must be legitimate and significant non-tax reasons for forming and funding the FLP. The discounts that are applied to value transfers of FLP interests should be ancillary benefits to achieving the non-tax goals. Even when there is a legitimate business reason for using an FLP, the IRS will audit the arrangement for gift and estate tax purposes, and there will be significant costs associated with this.

In many cases, it may not be readily apparent how a FLP would serve a strong non-tax purpose where the asset at issue is an equity interest in an operating business, such as a closely held corporation or an LLC, especially where the entity has a shareholder or operating agreement in place. In any case, where the entity is an S corporation the FLP cannot hold its stock at all without voiding the S election. However, in other cases, as where different family groups own different blocks of equity in a "C" corporation, it may be that there are valid business reasons to hold one group's shares through a FLP rather than to leave them in the hands of individual members.

Possible reasons for holding the stock of a C Corporation in a FLP might be to maintain block voting, to keep shares within the family, creditor protection, and to handle management succession. Bear in mind, however, that it still may be difficult to make the argument for a legitimate business purpose. Indeed, the IRS may find that there was no management of the shares contributed, no attempt to diversify or invest, just a mere "recycling" of value to generate discounts.

That being said, if a parent is in a position to utilize a FLP in connection with the transfer of business interests, consider these guidelines:

- Document the business reasons;
- Observe "corporate" formalities (documents, meetings, minutes, etc.);
- Do not contribute personal assets or co-mingle funds;
- Pool assets of various members (have the children contribute capital);
- Credit capital accounts properly;
- Share economics (e.g., distributions) pro rata;
- Use contemporaneous appraisals;
- Have separate counsel;
- Do not make gifts of FLP interests right away;
- Manage, invest, etc. (do something);
- No deathbed planning.

Redemption

Another means by which a parent may "shift" value to children-shareholders (without actually transferring anything to them), or position his or her estate for a better estate tax valuation result, is by way of a stock redemption. A redemption can reduce the parent's percentage interest in the redeeming business entity and increase that of the children-shareholders.

If the redemption is affected for FMV, there is no gift to the other shareholders, even though their relative interests increase. The removal of some of the parent's interests in the business freezes the value thereof by replacing it with cash that may be spent; the reduction in his or her percentage interest of the total equity may also put the parent in a less-than-controlling position, allowing for a minority discount at the time of his or her death.

In the case of a corporation, the redemption is generally an income-taxable event to the parent, though the specific consequences depend upon a number of factors, the primary ones being the status of the corporation as a C corporation, the presence of E&P from C corporation tax years, the taxpayer's stock basis, and the degree of reduction experienced by the parent (taking into account certain attribution rules). If the reduction is significant enough, the redemption may be treated as a sale of the stock redeemed, allowing recovery of stock basis before any capital gain is recognized and taxed. If not, then the amount distributed in the redemption is treated and taxed as a dividend distribution to the extent of E&P. Under the Code, both dividends and capital gains are taxed at the same 20 percent rate, the primary difference being the recovery of basis. Thus, where stock basis is low, as is often the case with closely held corporations, the tax consequences may be almost the same. In addition, the 3.8 percent surtax on net investment income must be considered. In any case, the income tax hit must be weighed against the potential transfer tax savings.

In the case of an LLC or partnership, the distribution of cash in partial or complete liquidation of the parent's interest will be taxable if the amount distributed exceeds the parent's adjusted basis in the interest. Any gain realized will generally be capital, though the presence of "hot assets" in the entity may change that result to some extent.

Conclusion

The last few posts have assumed that it was in the best interest of the family business that the parent transfer interests in the business to his or her children. In many cases, at least one of the children is capable of managing the business. In some cases, none of them is. In the latter situation (and sometimes even in the former), it may be imperative to the success and continued well being of the business – and to the financial security of the family – that one or more key employees (including family members) remain with the business after the parent's retirement or passing. This will be the subject of our next post.

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