Family Business Succession Planning

March 24, 2014
Transferring Your Family Business

As a business owner, you’re going to have to decide when will be the right time to step out of the family business and how you’ll do it. There are many estate planning tools you can use to transfer your business. Selecting the right one will depend on whether you plan to retire from the business or keep it until you die.

Perhaps you have children or other family members who wish to continue the business after your death. Obviously, you’ll want to transfer your business to your successors at its full value. However, with potential income, gift, and estate taxes, it takes careful planning to prevent some (or all) of the business assets from being sold to pay them, perhaps leaving little for your beneficiaries. Therefore, business succession planning must include ways not only to ensure the continuity of your business, but also to do so with the smallest possible tax consequences.

Some of the more common strategies for minimizing taxes are explained briefly in the following sections. Remember, none are without drawbacks. You’ll want to consult a tax professional as well as your estate planning attorney to explore all strategies.

You may get some relief under the Internal Revenue Code

If you are prepared to begin transferring some of your business interest to your beneficiaries, a systematic gifting program can help accomplish this while minimizing federal gift and estate tax liability (and state transfer tax liability, if applicable) that might otherwise be incurred. This is done by utilizing your ability to gift up to $14,000 (in 2013, $13,000 in 2012) per year per recipient without incurring transfer tax. By transferring portions of your business in this manner, over time you may manage to transfer a significant portion of your business free from transfer tax. Clearly, the disadvantage of relying solely on this method of transferring your business is the amount of time necessary to complete the transfer of your entire estate.

In addition, Section 6166 of the Internal Revenue Code allows any federal gift and estate tax incurred because of the inclusion of a closely held business in your estate to be deferred for 5 years (with interest-only payments for the first four years), and then paid in annual installments over a period of up to 10 years (installment payments include both principal and interest). This allows your beneficiaries more time to raise sufficient funds or obtain more favorable interest rates. The business must exceed 35 percent of your gross estate and must meet other requirements to qualify.

Selling your business interest outright

When you sell your business interest to a family member or someone else, you receive cash (or assets that you can convert to cash) which can be used to maintain your lifestyle or pay transfer taxes. You choose when to sell—now, at your retirement, at your death, or anytime in between. As long as the sale is for the full fair market value (FMV) of the business, it is not subject to transfer taxes. But if the sale occurs before your death, it may be subject to capital gains tax.

Transferring your business interest with a buy-sell agreement

A buy-sell agreement is a legal contract that prearranges the sale of your business interest between you and a willing buyer.

A buy-sell agreement lets you keep control of your interest until the occurrence of an event that the agreement specifies, such as your retirement, disability, or death. Other events like divorce can also be included as triggering events under a buy-sell agreement. When the triggering event occurs, the buyer is obligated to buy your interest from you or your estate at the FMV. The buyer can be a person, a group (such as co-owners), or the business itself. Price and sale terms are prearranged, which eliminates the need for a fire sale if you become ill or when you die.

Remember, you are bound under a buy-sell agreement: You can’t sell or give your business to anyone except the buyer named in the agreement without the buyer’s consent. This could restrict your ability to reduce the size of your estate through lifetime gifts of your business interest, unless you carefully coordinate your estate planning goals with the terms of your buy-sell agreement.
Grantor retained annuity trusts or grantor retained unitrusts

A more sophisticated business succession tool is a grantor retained annuity trust (GRAT) or a grantor retained unitrust (GRUT). GRAT/GRUTs are irrevocable trusts to which you transfer appreciating assets while retaining an annuity or unitrust payment for a set period of time. In general, an annuity means you receive fixed periodic payments, while a unitrust means you receive payments of a fixed percentage of trust assets (revalued annually). At either the end of the payment period or your death, the assets in the trust pass to the other trust beneficiaries (the remainder beneficiaries). The value of the retained annuity or unitrust interest is subtracted from the value of the property transferred to the trust (i.e., a share of the business), so if you live beyond the specified payment period, the business may be ultimately transferred to the next generation at a reduced value for transfer tax purposes.

Private annuities

A private annuity is the sale of property in exchange for a promise to make payments to you for the rest of your life. Here, you transfer complete ownership of the business to family members or another party (the buyer). The buyer in turn makes a promise to make periodic payments to you for the rest of your life (a single life annuity) or for your life and the life of a second person (a joint and survivor annuity). A joint and survivor annuity provides payments until the death of the last survivor; that is, payments continue as long as either the husband or wife is still alive. Again, because a private annuity is a sale and not a gift, it allows you to remove assets from your estate without incurring transfer taxes.

Grantor Retained Annuity Trust (GRAT)

**Definition**

A grantor retained annuity trust (GRAT) is an irrevocable trust into which a grantor makes a one-time transfer of property, and in which the grantor retains the right to receive a fixed amount (an annuity) at least annually for a specified term of years. At the end of the retained annuity period, the property remaining in the trust passes to the remainder beneficiaries or remains in trust for their benefit.

A transfer of property to an irrevocable trust is a taxable gift. The value of the gift on which federal gift and estate tax is imposed is generally its fair market value. However, because the grantor retains an interest in a GRAT, the value of the transfer is discounted; transfer tax is imposed only on the remainder interest.

**Note:** Any transfer tax due may be sheltered by the grantor's lifetime gift and estate tax applicable exclusion amount ($5,250,000 in 2013).

This taxable value is calculated using an interest rate provided by the IRS (known as the discount rate or Section 7520 rate), which
is based on current interest rates and changes monthly. This interest rate assumes the GRAT property will earn a certain rate of return during the annuity period. Any actual return that exceeds the assumed return passes to the remainder beneficiaries transfer tax free. Investment performance, therefore, is central to this strategy.

For a GRAT to be successful:

• The grantor must outlive the term of years
• The GRAT property must outperform the Section 7520 rate
• The GRAT document must be properly drafted

Potential tax advantages of a GRAT include:

• Because of the retained interest, the value of the transfer for federal gift and estate tax purposes may be discounted
• Principal remaining in the GRAT at the end of the term of years is removed from the grantor's gross estate for federal gift and estate tax purposes
• Interest (i.e., appreciation and/or earnings) remaining in the GRAT at the end of the term of years passes to the remainder beneficiaries federal gift and estate tax free

Key tradeoffs

• If the GRAT property underperforms the Section 7520 rate, no tax savings is achieved (and if the GRAT is depleted, no property is transferred to the remainder beneficiaries)
• If the GRAT property underperforms the Section 7520 rate, gift taxes paid and/or any applicable exclusion amount used will be wasted (though the amounts would be minimal)
• If the grantor does not outlive the term of years, any property remaining in the GRAT is includable in the grantor's gross estate for federal gift and estate tax purposes
• If the GRAT is unsuccessful, any costs incurred to create and maintain the GRAT will have been wasted

How is it implemented?

• Hire an experienced attorney to draft the GRAT document
• Have property that is transferred to GRAT professionally appraised
• Transfer property to GRAT (i.e., retitle assets)
• File gift tax return(s)

Grantor Retained Unitrust (GRUT)

Definition

A grantor retained unitrust (GRUT) is an irrevocable trust into which a grantor makes a one-time transfer of property, and in which the grantor retains the right to receive a variable amount (based on a fixed percentage of trust assets valued annually) at least annually for a specified term of years. At the end of the retained unitrust period, the property remaining in the trust passes to the remainder beneficiaries or remains in trust for their benefit.

A transfer of property to an irrevocable trust is a taxable gift. The value of the gift on which federal gift and estate tax is imposed is generally its fair market value. However, because the grantor retains an interest in a GRUT, the value of the transfer is discounted; transfer tax is imposed only on the remainder interest.

Note: Any transfer tax due may be sheltered by the grantor's lifetime gift and estate tax applicable exclusion amount ($5,250,000 in 2013).

This taxable value is calculated based on the value of the property transferred to the GRUT, the unitrust payout rate, the term of the trust, and using an interest rate provided by the IRS (known as the discount rate or Section 7520 rate), which is based on current interest rates and changes monthly. However, unlike with a GRAT, the Section 7520 rate has little or no effect on the value of the remainder interest in a GRUT.

A GRUT is the same type of trust as a grantor retained annuity trust (GRAT), except that with a GRAT, the grantor receives a fixed annuity amount rather than a variable unitrust payment. Because of this, payments to the grantor of a GRUT may increase or decrease each year depending on the value of the trust assets. And, because the unitrust payment must be recalculated each year, the cost to administer a GRUT may be greater than with a GRAT. Another important difference between these two trusts is that unlike a
GRAT, a GRUT can't be zeroed out, and therefore a taxable gift always results.

For a GRUT to be successful:

- The grantor must outlive the term of years
- The GRUT document must be properly drafted

Potential tax advantages of a GRUT include:

- Because of the retained interest, the value of the transfer for federal gift and estate tax purposes may be discounted
- Principal remaining in the GRUT at the end of the term of years is removed from the grantor’s gross estate for federal gift and estate tax purposes
- While not a tax advantage, if the value of the trust property increases, payments to the grantor increase, possibly providing protection against inflation

Key tradeoffs

- If the GRUT property performs poorly or is depleted, there may be less than anticipated transferred to the remainder beneficiaries and little or no tax savings
- If the grantor does not outlive the term of years, any property remaining in the GRUT is includable in the grantor's gross estate for federal gift and estate tax purposes
- If the GRUT is unsuccessful, any costs incurred to create and maintain the GRUT will be wasted
- If the value of the trust property decreases, payments to the grantor decrease, and may not provide enough income
- If payments to the grantor increase because the value of the trust property increases, the additional payments will be included in the grantor’s gross estate for federal estate tax purposes unless consumed or given away

How is it implemented?

- Hire an experienced attorney to draft the GRUT document
- Have property that is transferred to the GRUT professionally appraised
- Transfer property to GRUT (i.e., retile assets)
- File gift tax return(s)

Planning for Succession of a Business Interest Flowchart

Do you have management readily available to run your business?

CONTINUED
Your business could be continued if you take the necessary steps

SOLD
Provide that you have an enforceable buy-sell agreement and sufficient funding to assure the sale

LIQUIDATE
Your entire interest may be terminated by a series of distributions

<table>
<thead>
<tr>
<th>KEY</th>
<th>NO</th>
<th>YES</th>
</tr>
</thead>
</table>

Do you have a qualified buyer for your business?

Is there family active in your business that will continue to be involved?

Would your family be provided with sufficient income from your business?

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# Business Succession Planning Alternatives

<table>
<thead>
<tr>
<th>If you want to:</th>
<th>Lifetime gifts</th>
<th>Bequest</th>
<th>Lifetime sale</th>
<th>Estate sale</th>
<th>Buy-sell agreement</th>
</tr>
</thead>
<tbody>
<tr>
<td>Sell your business interest</td>
<td>Not appropriate</td>
<td>Not appropriate</td>
<td>You may be able to sell your business outright but there is no guarantee</td>
<td>Your estate may be able to sell your business outright but there is no guarantee</td>
<td>Buy-sell agreement can be used to guarantee the sale of your business</td>
</tr>
<tr>
<td>Give business to your children</td>
<td>You can control the timing and size of the gifts</td>
<td>You control the size of the gift through your will</td>
<td>Not appropriate</td>
<td>Not appropriate</td>
<td>Not appropriate</td>
</tr>
<tr>
<td>Sell business to your children</td>
<td>Can be used in conjunction with sale</td>
<td>Not appropriate</td>
<td>You can control timing of sale—but sale is not guaranteed</td>
<td>Your child could buy from your estate—but sale is not guaranteed</td>
<td>Buy-sell can be used to guarantee your child’s option to buy your interest</td>
</tr>
<tr>
<td>Minimize value of your estate</td>
<td>Can be used to reduce the value of your estate and maximize gift tax exclusion</td>
<td>Will not minimize value of your estate</td>
<td>You can control timing of sale—but sale is not guaranteed</td>
<td>Value of business must be included in your estate</td>
<td>Value of business must be included in your estate, but the buy-sell can help establish that value</td>
</tr>
</tbody>
</table>
## Business Succession Planning: Comparison of Alternatives

<table>
<thead>
<tr>
<th></th>
<th>FLP</th>
<th>Private Annuity</th>
<th>SCIN</th>
<th>GRAT</th>
<th>Lifetime Gifts</th>
</tr>
</thead>
<tbody>
<tr>
<td>Minimize Federal Gift Tax</td>
<td>Yes(^1)</td>
<td>Yes(^2)</td>
<td>Yes</td>
<td>Yes(^2)</td>
<td>No</td>
</tr>
<tr>
<td>Minimize Federal Estate Tax</td>
<td>Yes(^3)</td>
<td>Yes(^4)</td>
<td>Yes(^4)</td>
<td>Yes(^4)</td>
<td>Yes(^3)</td>
</tr>
<tr>
<td>Minimize Federal Income Tax</td>
<td>Yes(^5)</td>
<td>No</td>
<td>No</td>
<td>No</td>
<td>Yes(^5)</td>
</tr>
<tr>
<td>Minimize Federal Capital Gains Tax</td>
<td>Yes(^6)</td>
<td>No</td>
<td>Yes</td>
<td>Yes(^6)</td>
<td>Yes(^6)</td>
</tr>
<tr>
<td>Income for Transferor</td>
<td>Yes</td>
<td>Yes</td>
<td>Yes</td>
<td>Yes</td>
<td>No</td>
</tr>
<tr>
<td>Control by Donor</td>
<td>Yes</td>
<td>No</td>
<td>No</td>
<td>Yes</td>
<td>No</td>
</tr>
<tr>
<td>Creditor Protection</td>
<td>Yes(^7)</td>
<td>No</td>
<td>No</td>
<td>No</td>
<td>Yes</td>
</tr>
<tr>
<td>Risk</td>
<td>No</td>
<td>Yes(^8)</td>
<td>Yes(^8)</td>
<td>No</td>
<td>No</td>
</tr>
</tbody>
</table>

1. Value of gifted interest may be discounted, otherwise eligible for annual and lifetime gift tax exemptions
2. To the extent fair market value of business does not exceed present value of annuity
3. Shifts future appreciation to children
4. But not to the extent payments are received and increase the transferor's estate value
5. Shifts income to children
6. But note that donees do not receive a "step up" in basis on transferred assets
7. Limited partners generally have no personal liability for partnership debts
8. Transferor may not live long enough to receive full payment
# Overview of Buy-Sell Agreement Forms

<table>
<thead>
<tr>
<th>Agreement form</th>
<th>Buyer</th>
<th>Works well with</th>
<th>Unsuitable for</th>
</tr>
</thead>
<tbody>
<tr>
<td>Wait and see</td>
<td>Business entity, co-owner, or both</td>
<td>Business with two or more owners</td>
<td>Sole proprietor and single-shareholder corporation</td>
</tr>
<tr>
<td>Trusteed cross purchase</td>
<td>Co-owner Transaction overseen by trustee</td>
<td>Business with two or more owners Simplifies plan when large number of owners</td>
<td>Sole proprietor and single-shareholder corporation</td>
</tr>
<tr>
<td>Entity purchase (stock redemption)</td>
<td>Business entity</td>
<td>Business with two or more owners</td>
<td>Most expensive type</td>
</tr>
<tr>
<td>Section 302 stock redemption</td>
<td>Business entity</td>
<td>Business with two or more owners</td>
<td>Sole proprietor and single-shareholder corporation</td>
</tr>
<tr>
<td>Section 303 stock redemption</td>
<td>Business entity</td>
<td>Business with two or more owners, especially family business</td>
<td>Sole proprietor and single-shareholder corporation</td>
</tr>
<tr>
<td>Reverse Section 303 stock redemption</td>
<td>Business entity</td>
<td>Business with two or more owners, especially family business</td>
<td>Sole proprietor and single-shareholder corporation</td>
</tr>
<tr>
<td>Cross purchase (crisscross) agreement</td>
<td>Co-owner</td>
<td>Business with two or more owners</td>
<td>Sole proprietor and single-shareholder corporation Large number of owners (gets complicated with four or more)</td>
</tr>
<tr>
<td>Option plan</td>
<td>Business entity, co-owner, or any eligible third party Sale not guaranteed</td>
<td>Business with any number of owners, including sole proprietorship and single-shareholder corporation</td>
<td>Any scenario where guaranteed sale is needed</td>
</tr>
<tr>
<td>One-way buy-sell</td>
<td>Business entity, co-owner, or any eligible third party</td>
<td>Business with any number of owners, including sole proprietorship and single-shareholder corporation</td>
<td>Sole proprietor with no willing buyer</td>
</tr>
</tbody>
</table>
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