# GETTING FAMILY BUSINESS OWNERS OFF THE DIME:

## HOW TO GET THEM STARTED ON ESTATE AND BUSINESS SUCCESSION PLANNING

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# Getting Family Business Owners Off the Dime: How to Get Them Started on Estate and Succession Planning

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One of the most difficult challenges facing those who advise owners of family businesses is to get them to take the first step in the planning process. You are familiar with the numbers: eighty percent of family businesses to do not pass successfully to the second generation; of the twenty percent which do pass successfully, eighty percent of them never make it to the third generation.

People blame this incredible failure rate on death tax; however, taxes are not the problem. You can plan to minimize and to pay the tax, but you cannot plan around the entrepreneur's refusal to face his or her own mortality and to make difficult (and emotional) decisions about which child will run the business in the future.

Family business owners typically adopt the Scarlet O'Hara approach to succession planning: "I will worry about that tomorrow, for tomorrow is another day." Because there always is a tomorrow, they never get around to it.

What will motivate your family business owning client to engage in thoughtful estate and business succession planning? How do you get him or her off the dime? How do you get them started?

I will describe a number of issues which may (or may not) be significant to a particular client. Each family business owner is different, of course. An issue which may be critical to one business owner may not be at all important to another. You know your client. What will motivate this particular client to start down the road?

Too many advisors present many alternative (and sometimes conflicting) strategies, leading the business owner to conclude that this planning is an all or nothing thing.

I recommend, in the alternative, that you make the first step as small as possible, just to get the family business owner started on the path to business succession planning. Do not let the client think that everything must be done at once. Try to avoid complicated design schematics, which are meant to diagram the entire end result on one piece of paper. I had one client tell me later that the paper looked like "the wiring diagram for a nuclear submarine." Why make the first step so big?

Start with the low hanging fruit, such as a simple update to the client's estate planning documents and buy-sell agreement. After the owners begins the process, I have found it is easier to keep them going.

While the focus of this paper will be on the planning and drafting of the actual documents, care must be taken not to loose sight of the fact that the lawyer is drafting documents and implementing the decisions made by the client. The planning process itself is insurmountably linked to the drafting process.

Therefore, some of what follows is arguably in both the planning and drafting categories, as one cannot be separated from the other.

## Cash Flow for the Surviving Spouse

This is one of the most critical issues which must be addressed as part of the family estate and business succession plan. If the owner has been taking cash flow out of the business in the form of compensation, how will the surviving spouse get cash when her husband dies and his pay check stops?[1]

The business owner who believes the business will continue its earnings uninterrupted by his death must determine how those earnings will get out of the business to his widow. What makes him think that the business will declare a dividend for the first time in its history beyond what is needed to pay income taxes?

The business owner who puts his ownership interest in trust for the benefit of his widow may mistakenly assume that the trustee will vote that ownership interest in favor of a dividend or distribution. There will not be a cash flow problem, they argue, because the stock will be voted in favor of a dividend.

Advise that client that it is the trustee who must vote the shares which are held in trust. If the trustee is a child who is active in the business, how likely is it that the trustee will vote in favor of a dividend at a time when the child believes the money needs to stay in the business? Certainly, the child/trustee has a conflict of interest (which I will address later in this paper); however, the real world intrudes to make unrealistic the assumption that the trustee will, of course, vote the trust shares in favor of a dividend.

Even if the surviving spouse is the trustee and can unilaterally vote the shares in favor of a dividend, what intra family disputes may arise in that situation? Perhaps some of the children are now the managers of the business and they argue that the business cannot afford a dividend at this time, particularly after the death of the entrepreneur. A widow who, as trustee, forces a dividend on the younger managers of the family business could easily create a family riot, particularly if the widow is a second childless spouse. I have seen three businesses get ripped apart within two years of the owner's death because of these exact family turmoils.

You may have an estate plan which mandates the distribution of "all the net income" to the surviving spouse from a credit trust and from a marital trust, but what "income" is really going to be available to distribute? If no dividends or other distributions are made from the business to the trustee, there will be no cash flow for the surviving spouse.

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1 For ease of presentation, this paper will assume that the family business is owned by a man; the pronoun should be read to be interchangeable as more and more family businesses are started by and owned by women.

The business owner and his advisors need to address this critical issue as part of the succession planning/estate planning process. The worst time to start this conversation is on the way home from the entrepreneur's funeral! Deal with it now, while everyone is still alive.

Available alternatives include those non-business assets which will produce income after the business owner's death, including the proceeds of life insurance and the proceeds of any sale of an ownership interest pursuant to the provisions of a buy-sell agreement. Recall, however, that there may be no proceeds under the buy-sell agreement if ownership of the business is to stay within the family and if the transfers made by the deceased owner are permitted under the agreement with no stock to be purchased.

If the business is going to stay in the family after the death of the primary owner, he might give consideration to the acquisition of more life insurance as a way to create income producing assets for his widow. Certainly the premiums will be expensive if the owner is elderly and he may no longer be insurable. Nevertheless, consideration of more life insurance may be appropriate.

If more insurance can affordably be acquired, the advisor should determine whether the new policy should be acquired by the business owner or by the trustee of an irrevocable life insurance trust.[2] If the business owner is the applicant and owner of the new policy, he may be making his own estate tax situation more complex. If, instead, he creates an irrevocable life insurance trust, gives to the trustee an amount equal to the initial premium cost and the trustee applies for and becomes the owner of the new policy, the proceeds will be paid into the irrevocable life insurance trust free of federal estate tax no matter when the business owner dies. Presumably, the widow will be the income beneficiary of the life insurance trust.

The business might give consideration to a deferred compensation plan, payable to the business owner upon his retirement and, more importantly, continuing for the rest of his widow's lifetime.

Finally, the business might today (while the owner is very much alive) create a written dividend policy to become applicable after the owner's death. It might provide, for example, that the business will declare a dividend or make a distribution to the owners in a stated percentage if earnings reach a certain carefully defined level. If the business adopts this policy now, its later implementation will not be just at the widow's insistence, but will merely be carrying out the deceased owner's planning.

The issue of cash flow for a surviving spouse may be a case of the drafting driving the succession planning; that is, the mere drafting of a provision which mandates the distribution of "all the net income" to the widow should compel the planner and owner to address this critical planning issue now.

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2 If the spouse is a beneficiary of the irrevocable life insurance trust, be certain that premiums are paid solely from the separate property of the insured spouse in community property states; if community property or the spouse's separate property is used to pay premiums, the surviving spouse will be deemed to have gifted assets to the trust, possibly causing estate inclusion under Section 2036 of the Internal Revenue Code of 1986, as amended (the "Code").

The Business Real Estate

Many business owners maintain separate ownership of the business real estate, which is then leased to the business. If the entrepreneur is married, the business real estate may be owned by the husband and wife in their joint names. If the entrepreneur is not married, the business real estate may be in his or her individual name.

*Limit the owner's personal liability.* If the real estate is separately owned, the real estate owner(s) has personal, unlimited liability for industrial accidents which might happen on the property.

I recommend that title to the business real estate be put into a limited liability company, owned by the person (or couple) who previously owned the business real estate, so as to limit the owner's liability to the assets of the LLC. His or their separate investment accounts should be protected from the personal liability which they have today.

*A longer term lease.* Be certain that there is a written lease between the LLC and the business. Many leases I have reviewed have short terms, some as low as five years.

The risk of a short term lease comes when the entrepreneur dies and the business is sold and moved to a new location. If the owner dies in year three of a five year lease, the widow will be assured of continued rent payments from the purchaser of the business for only two more years.

If the buyer of the business were to move the business out of the location where it was previously, the widow may shortly find herself the owner of a very large, very empty building which is retrofitted for a particular purpose and will be very difficult to release or sell.

I recommend that the term of the lease be lengthened to as much as twenty years, with provisions for regular rent increases. If the business were sold and moved after the entrepreneur's death, the buyer will either have to continue the rent payments throughout the term of the lease or to buy out the lease. The latter (more common) approach is a way in which a portion of the purchase price of the business can be shared with the surviving spouse.

*Give control of the real estate to the beneficiary who will control the business.* Many business succession plans go to great lengths to give control of the family business to that child who works with the entrepreneur. The estate planning documents are frequently used to carry out this planning, typically in the form of specific bequests to the business child of voting interests in the business. The estate plan then may go on to leave all the entrepreneur's other assets to the non-business children in an effort to equalize the gifts.

If those "other assets" include the business real estate, the child who controls the business will find that he or she must seek the approval of the non-business siblings every time the business child wants to repave the parking lot, fix the roof or make any other change to the building and real estate on which the business is located.

If the business succession plan results in non-voting ownership interests being given to the non-business children, it is not unusual for them to refuse to consent to anything requested by

the business child so long as he or she continues to take earnings from the business in the form of compensation and refuses to make distributions to all the owners of the business (including the owners of the non-voting stock).

Why give that type of veto power to the non-business children? I recommend that control of the business real estate be given to that child who is given control of the business. Voting and non-voting interests can be utilized to give effective control, but not a huge dollar value, to the business child and an equivalent amount of non-voting equity to the non-business children.

The future relationship between the business and the real estate LLC will mirror today's situation; that is, the same person serves as both landlord (the LLC) and as tenant (the business). That is how it is operated today: the business leases the real estate from the entrepreneur. That relationship should not change.

## Children who do not work in the business

Many business succession plans contemplate the transfer of voting shares to those children who work in the business and non-voting shares to those children who do not work in the business.

Does the business buy-sell agreement provide an "exit strategy" for those children who receive non-voting shares? Conversely, does the buy-sell agreement permit the owners of the voting shares to buy out the owners of the non-voting shares?

Those non-voting shares have real value; however, the owners of those shares may not be able to realize that value. How can the non-voting shares be sold? An appraiser may have told the owner of non-voting shares that, after all appropriate valuation discounts, the stock is worth $980,000, for example. But how can that shareholder convert the stock certificate into that much cash?

If the children who receive the voting shares refuse to purchase the non-voting shares, there is no other market for those shares. The buy-sell agreement may prohibit sales to an outsider in any event.

I suggest that the buy-sell agreement permit the owners of non-voting shares to compel either the business or the owners of the voting shares to purchase their stock (the non-voting shareholders are given a "put"). The purchase price, determined under a formula set forth in the buy-sell agreement (which would specify whether the inherent value of the non-voting shares should be discounted for minority interest, lack of marketability and lack of vote), would be paid to the sellers of the non-voting stock over a period of years with interest.

This provides a mechanism for the non-business children to realize the value of their non-voting stock, but to do so in a way which hopefully can be paid over time out of the business earnings.

In a similar fashion, the children who own the voting shares can be given a "call," so they can force the non-business children to sell their non-voting stock whether they want to do so or

not. If the business children are not given a call, the results all their efforts to grow the business will be shared by the non-business children who made no contribution to that success. If the owners of the voting shares were to buy the non-voting shares over time, however, the conversion of this equity into debt would mean that the appreciation of the value of the business, attributable to the efforts of the owners of the voting stock, would inure solely to be benefit of the owners of that voting stock.

Once again, the buy-sell agreement can specify the purchase price to be paid for the non-voting shares, determined under a formula set forth in the agreement (which would specify whether the inherent value of the non-voting shares should be discounted for minority interest, lack of marketability and lack of vote), which would be paid to the sellers of the non-voting stock over a period of years with interest.

## The Trustee

Who will serve as the trustee who will carry out the estate and business succession plan? What conflict of interest problems exist for whoever serves as trustee?

*Corporate fiduciaries.* Corporate fiduciaries may be unwilling to act as trustee when the trust assets consist of an ownership interest in a family business. Many bank trust departments do not want the liability which accompanies that responsibility. If the trust holds a controlling interest in the business, corporate fiduciaries are naturally aware of the management, as well as the fiduciary, responsibilities which the trustee will have.

Even if the trust will hold only a minority interest in the family business, many bank trust departments are reluctant to act as trustee and assume the state law duties of a minority shareholder in order to fulfill their fiduciary responsibilities to the trust beneficiaries.

If the business owner selects an individual to serve as trustee, on the other hand, he must identify a successor trustee in case the first selection is unable or unwilling to serve as trustee after the owner's death. The estate plan may include a string of individuals, with a provision calling for the beneficiaries to select a corporate fiduciary to act after all the named people have left the scene.

Before you routinely include this catch all provision in all of your estate planning document, I recommend that you canvass the corporate fiduciaries in your market. Without disclosing any client confidences, you can reasonably inquire as to the policies of each bank trust department with regard to serving as the trustee of a trust which holds an interest in a closely held family business. Do not be surprised if most, if not all, of them state that they would decline to serve.

If your document mandates the selection of a corporate fiduciary after all the named individual trustees are unable or unwilling to serve, what does your local law state if you cannot find a bank trust department which is willing to serve? Does the local court then appoint the successor trustee? Is the business owner, whom you are advising on this critical issue, comfortable leaving that selection up to the local court having probate and trust jurisdiction? If not, consider other alternatives, such as permitting the beneficiaries to select the successor

trustee, which does not have to be a corporate fiduciary, so long as the new trustee is not a beneficiary and is not related or subordinate to the beneficiary within the meaning Code Section 672(c).

*The surviving spouse as trustee.* So long as the trustee may distribute trust principal, in the trustee's discretion, for only the health, education, maintenance and support of the surviving spouse, there is no tax reason why the surviving spouse cannot serve as trustee. Nevertheless, there may be conflict of interest and family reasons why the surviving spouse may not be a wise choice as trustee.

The widow who serves as trustee may have a legitimate interest in her own cash flow, which can create conflict of interest reasons why it may not be the best idea to name the surviving spouse as trustee. The widow/trustee may vote the trust shares in favor of a significant dividend over the objections of those who are actually managing the family business. The trustee may be a significant or even a majority owner of the business, with fiduciary responsibilities under state law to the other owners of the business and to its employees, officers and so forth. Those responsibilities imposed upon the trustee, as business owner, can be in conflict with the personal interests of the widow/trustee who seeks to enhance her cash flow.

The business owner who considers the spouse as a trustee candidate must also be advised that the widow/trustee may then be in a position to control the business. If the business owner is comfortable with this, there is no business reason not to name the spouse as the trustee. However, if this spouse has never been active in the business, has her own career, is a second childless spouse or has a history of "instability," there may very well be a business reason why that spouse should not serve as trustee.

*A child as trustee.* It is tempting for the business owner to name as trustee that child who is going to manage the family business after the death of the entrepreneur. But what conflict of interest problems will that child have as trustee? It is more than likely that his or her responsibilities as the new manager of the business will come into conflict with the fiduciary duties which are imposed on the trustee.

The trustee, of course, has a fiduciary obligation to take those steps which are in the best interests of the beneficiaries of the trust. The manager of the business has an obligation to take those steps which are in the best interests of the business and its owners. Those two obligations can easily come into conflict over decisions about dividends or other distributions to the owners, expansion of plant, property and equipment, new business ventures and so forth.

*The key manager as trustee.* Some owners prefer to name as trustee one or more key managers who have been with the business for decades. Who else knows the business as well and who else will be able to manage the business after the owner's death? That key manager will become the trustee and, as majority owner, will be able to run the business as the owner would have done if living.

However, this key manager also has the same fiduciary duties as trustee and manager. Added on top of those responsibilities may be a long friendship with the widow and some emotional guilt over the death of the owner while the key manager is still living.

How will this key manager/trustee overcome the conflicts of interest and emotional conflicts when making decisions about dividends and so forth? How will he deal with his conflicting duties to the widow and the business?

*Waiver of conflict of interests.* If the business owner wishes to proceed with the naming of an individual trustee in spite of these conflicts of interest, it is important that the estate planning documents acknowledge and waive the conflicts. A draft clause is attached to this material for your consideration.

*Removal of the trustee.* It is critically important to give one or more of the beneficiaries the power to remove any corporate fiduciary which may be serving as trustee. With all that has happened in the financial industry over the past fifteen years, no one wants to be held hostage by a corporate trustee which cannot be fired. There are countless examples of a decedent who named his local bank as trustee, only for his widow to learn that she is now dealing with some gigantic bank in another state.

But what consideration should be given to the removal of an individual who is serving as trustee? Today's trusted advisor may become an irrational, stubborn and even angry person as he or she becomes older. I have experience with situations in which a now elderly trustee became more and more autocratic and tyrannical over time. The power which a trustee has over the beneficiaries can be quite an aphrodisiac and one which is difficult to relinquish.

Should the business owner consider a stated retirement age for any individual who is serving as trustee? There is anecdotal evidence that the old mandatory retirement age of sixty-five was selected in Germany by a wish to "retire" the older, senile generals who were over that age. Can a similar approach be taken with respect to the trustee? Of course.

If the business owner is reluctant to force a trusted colleague to retire as trustee due to age alone, can the beneficiaries be given the power to remove the trustee for stated reasons? For example, if the trustee arbitrarily refuses to exercise the discretionary power to distribute trust principal ("I don't care why you need money, the answer is 'no!'"), if the trustee arbitrarily abuses his powers as the majority owner of the business ("I forbid any expansion!") or if the trustee seeks to sell the family business over the objections of the beneficiaries, the document could grant to designated beneficiaries the power to remove the individual trustee for cause.

This type of removal for cause provision in the estate planning documents is preferable to the public need to seek the court removal of the trustee merely for some undefined cause; however, the trustee who refuses to relinquish his position ("I am not being arbitrary and the provisions of the trust agreement have not come into play based on my interpretation of the facts") may easily lead the family into court. Nevertheless, provisions of this type can be very persuasive to a judge who is seeking some insight into the business owner's intentions.

*Co-Trustees.* Some business owners will select two individuals to serve as co-trustees, perhaps a family member serving with a key manager of the business. Depending on state law, it is likely that the decisions of co-trustees must be unanimous unless the document provides otherwise.

As the family member and the key manager will necessarily each have their own

agendas, deadlocks between the co-trustees can be very possible. Whenever there is no unanimity between the co-trustees, that trustee who wishes to take a specific action looses. Each trustee is given a veto over the decisions of the other trustee.

One solution is to provide for tie breakers in the estate planning documents. The business owner, for example, could provide that the decision of his key manager/co-trustee will control if there is a disagreement over management of the business and that the decision of the family member/co-trustee will control if there is a disagreement over discretionary distributions to family members.[3] The disagreeing co-trustee must be relieved of liability for going along with the decision of the "veto holding" co-trustee.

The estate planning document should be very clear as to the procedure if one of the two co-trustees resigns, becomes incapacitated or dies. Must there be a new co-trustee or may the surviving co-trustee continue to serve alone? Must there always be a representative of the family and a representative of the business serving together? If the surviving co-trustee may serve alone, does he or she then have all the powers of the trustee, including those over which the other co-trustee previously had a veto power?

*The trustee who must follow the direction of a third party with respect to the business.* In order to avoid the trustee's conflict of interest problems, the business owner might name one individual to serve as trustee, but give to a key manager or other third party the power to direct the trustee with respect to business interests which are held in the trust.

The trustee should be relieved of liability for complying with the written directions of this third party. The document must specify what is to happen if the named third party resigns, becomes incapacitated or dies. What is the mechanism for selecting a new person who can direct the trustee?

Consideration should be given to the power to remove this third party from the position of control. The same considerations for removal for cause, discussed previously with respect to the trustee, arise in this connection. If the trustee can remove the advisor and can name a successor advisor for any reason, the trustee necessarily has liability for the actions of the advisor; therefore, the power to remove and to appoint a successor advisor should be given to one or more of the beneficiaries.

What limits should be placed on the powers of this independent third party? If the trust owns less than 100% of the ownership interests in the family business, should the trust instrument require the approval of a majority of the beneficiaries (the income beneficiaries only or include the remainder beneficiaries?) before certain corporate actions are taken, such as a pledge of corporate assets to secure a loan, a sale of the business or a majority of its assets and so forth?

Attached as an exhibit to this material is a sample provision on this issue for your consideration.

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3 If the family member/co-trustee is a beneficiary to whom discretionary distributions might be made, limits must be placed on his or her ability to exercise this power, so as to avoid having general power of appointment problems.

Position the Surviving Spouse to Get Valuation Discounts

Many owners of family businesses read about valuation discounts in trade journals. They become convinced that the value of their business for tax purposes will be reduced by 30%, 40%, 50% or even more! Is this an accurate assumption?

The availability of valuation discounts depends on the ownership interest which is being valued. If the interest to be valued represents more than 50% of the equity in the business, no discount for minority interest will be available (although a modest discount for lack of marketability might be taken). The substantial discounts which our clients seek are available only if the interest to be valued is a minority interest in a family business with no market for resale.

Consider the typical estate plan for a family business owner who dies before his wife: he puts the maximum amount into a credit trust and leaves his remaining assets to his wife. Suppose the business is worth $12 million when he dies.[4] If Congress makes "permanent" the $5 million exemption, he will put $5 million in his credit trust and will give the remaining $7 million (plus his other assets) to his wife.

There is no estate tax when the business owner dies because the $5 million in the credit trust is sheltered by his applicable credit amount and the remaining $7 million is deductible as a marital transfer.

But what happens when the surviving spouse later dies? Her gross estate will include her $7 million ownership interest, which represents 58.3% of the equity in the business. No discount for minority interest will be available and her estate will pay estate tax based on the real, undiscounted value of her ownership interest.

If the owner's wife were to die first, on the other hand, the business owner's estate will later be taxed on the full $12 million value of the business with no discounts for minority interest when he dies.

The business owner needs to take two steps now in order to position the surviving spouse's estate to be eligible for valuation discounts:

1. ownership of the business[5] should be divided equally between the husband and wife[6] and each them should then give at least one share away to the children or elsewhere; and

2. each of them should have an estate plan which includes a credit trust and a QTIP trust at the first death, rather than another form of marital transfer.

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4 Either as his separate property or his portion of the community property.

5 If the business is already community property, this has already been taken care of.

6 An irrevocable lifetime QTIP trust could also be used in situations in which the business owner (for any reason) is unwilling to make an outright gift to his wife.

After the first of these two steps, neither spouse owns even 50% of the equity in the business. Each is a minority owner.

When the first spouse dies (whichever one of them it turns out to be), he or she will put $5 million in the credit trust and the remaining $1 million in the QTIP trust. There will still be no federal estate tax when the first spouse dies.

When the surviving spouse later dies, his or her gross estate will include the stock which is held in the QTIP trust and the stock which is owned outright by the surviving spouse.

The Service attempted for years to aggregate these two blocks of stock, so that the combined stock will represent more than 50% of the equity in the business. The courts did not agree with this position, holding that each block of stock must be valued separately and independently from the other block.[7]

The IRS acquiesced in the *Mellinger* case.[8] Each block of stock (one block is the stock held in the first spouse's QTIP trust and the second block is the stock owned by the surviving spouse) is valued independently. Because each block represents less than 50% of the equity,[9] each block is entitled to discounts for minority interest and lack of marketability.

It is important for advisors to alert their clients who own family businesses that valuation discounts must be earned. If the ownership interest to be valued upon the death of a surviving spouse represents a majority interest in the business, valuation discounts will be insignificant.

The two steps listed above must be taken *before the first spouse dies*. If that first spouse stays with a plan which leaves more than 50% of the ownership interest in the business to the surviving spouse (outright or in a marital trust), it is too late; the surviving spouse's estate will not be eligible for valuation discounts unless he or she makes enough lifetime gifts to bring the ownership interest to less than 50%.

The QTIP trust can be limited to the first spouse's business interest, with other non-business assets left outright to the surviving spouse.

This is a critical issue for any client whose business is today worth more than $10 million (let alone what it will be worth when the first spouse dies)!

## Buy-Sell Agreements

One easy example of "low hanging fruit" is your client's buy-sell agreement.

Many owners of family businesses take comfort from having a buy-sell agreement in place. Most new (and even existing) clients may exclaim "We already have a buy-sell

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7 *Estate of Bonner*, 84 F3d 1996 (5th Cir. 1996); *Estate of Lopes*, T.C. Memo. 1999-225; and *Estate of Mellinger*, 112 T.C. 26 (1999).

8 1999-2 C.B. XVI, 1999035 I.R.B. 314 (August 30, 1999).

9 Remember that, after the first step, neither spouse owns even 50% of the equity; therefore, neither the QTIP trust nor the surviving spouse's own stock can be more than 50% of the equity.

agreement!" But is the agreement up to date? Does it anticipate all the various ways in which it might be used? Does the client even know what it says?

"It's just a form," they argue. "They are all the same and you just change the name of the company!" That is not true, of course.

I recommend that you review the agreement which your client may already have in place and consider several issues which may not have been adequately addressed by the existing buy-sell agreement.

<u>The valuation mechanism is unclear, inappropriate or out of date</u>

The manner in which the price to be paid when the buy-sell agreement is triggered should be set forth in the agreement. This might be a formula, a fixed price or a value determined by appraisal.

*Is the wording in the agreement clear?* I have reviewed agreements in which the formula is subject to numerous, conflicting interpretations. The value set forth in the agreement, for example, may depend on the "income" of the business, without specifying whether it is gross income or net income or before tax or after tax. If the price depends on the "value" of business assets, does that mean depreciated value or appraised fair market value?

The drafters of these agreements may have felt that the wording was not only clear, but that it was capable of only one interpretation; unfortunately, the formula will be applied by appraisers, lawyers and owners who may not know what the words are *supposed to* mean. Rather, they can only work with what they think the words *actually* mean.

If the pricing formula is set forth in the buy-sell agreement itself, I suggest that you "test" the wording by asking a disinterested professional to apply the formula to the actual numbers (earnings, assets and so forth) of the business now. Do the owners agree with the results of this impartial interpretation of the formula? If the value, as determined by this third party professional, differs dramatically from the expectations of the owners, it seems certain that the wording of the formula needs work!

*If a formula price is provided in the agreement*, is it appropriate for the business? I have seen an agreement for a dental practice which determined the value based on the book value of the assets, rather than the earning capacity of the practice, for example.

The real value of the dental practice was much more dependent on its earning capacity, perhaps averaged over a number of years, than on the appraised value of the dental equipment. How much is that equipment worth, when compared with the income which a skilled dentist could earn through its use? What is the real value of the practice?

*If a fixed price appears in the buy-sell agreement*, is the price kept up to date? If the agreement sets a fixed price and states that the owners will update the price periodically, what happens if they fail to do so?

Suppose, for example, that the agreement calls for annual updates of the fixed price (after

the end of each fiscal year, perhaps), but the last price set forth was determined eight years before the event that triggered operation of the agreement?

Does the old number still govern? Do you shift to appraisals at that point? How out of date must the fixed price be before an alternative course of action is taken?

Does the agreement specify what is to happen if the owners fail to update the fixed price? If the buy-sell agreement is silent on this point, it is likely that the price will ultimately be set by a court which decides the lawsuit between the seller and the buyer. Only the lawyers "win" in that case.

I recommend that the agreement, rather than some judge, determines what is to happen if the owners of the business fail to set the price on the schedule set forth in the buy-sell agreement. You might specify that the value is to be determined by appraisal if the price set forth in the agreement was fixed more than twelve months prior to the triggering event, for example.

*If the value is to be determined by an appraisal*, who selects the appraiser? If both the buyer and the seller select their own appraisers, what happens to the resulting, frequently different values? Do you simply average the two values to determine the purchase price?

The agreement might specify that, if the difference between the two initial appraisals is significant enough (which must be a defined term in the agreement), the two appraisers will select a third appraiser who sets the value. But what if the two initial appraisers cannot agree on a third appraiser? Who pays for all the appraisals? The agreement needs to answer these questions.

Valuation discounts

The stock which is purchased under the buy-sell agreement will typically represent a minority interest in a family business which has no other readily available market for resale. Valuation experts can determine the value of the business itself and can then quantify the minority interest and lack of marketability discounts. These discounts could reduce the value of the stock by as much as 30-40% (or more) from the inherent value of the stock.

Does the buy-sell agreement specify whether the purchase price is to be discounted for minority interest and lack of marketability? If the interest to be valued is a minority interest (and it almost always is) and if the value is to be determined by an appraisal (with a goal of determining the "fair market value" of the ownership interest), the value will usually will be *after* valuation discounts.

*Fair market value* means the price which a willing buyer would be willing to pay for a minority interest in a family business with no market for its resale. That value will usually *not* be one hundred cents on the dollar.

Is this what the owners want to have happen? Frequently, the answer to this question is an emphatic "No!" That is, each owner fully expects to receive his or her pro rata share of the value of the entire business if an interest is sold under the buy-sell agreement. But if the goal of

the appraisal is fair market value, that price will typically be *after* all appropriate valuation discounts if the interest to be valued is a minority interest in a family business with no market for resale, unless the buy-sell agreement provides otherwise.

I suggest that you ask the owners now (before any triggering event takes place) to think about each event which will cause an ownership interest to be purchased under the buy-sell agreement: death; permanent disability; divorce; voluntary termination of employment; involuntary termination of employment; bankruptcy; assignment of an ownership interest to creditors; disclosure of confidential information and so forth.

Should the price be discounted in *every* instance when the buy-sell agreement is triggered?

The owners, for example, may wish the selling shareholder to receive an undiscounted price in the event of death, permanent disability or retirement. Conversely, a discounted price might apply in the event of divorce, involuntary termination of employment or bankruptcy.

Some buy-sell agreements might provide that an owner's involuntary termination of employment would trigger the purchase of his or her stock. The agreement might have been created when the business was formed and no owner knew at that time which one of them might be fired or was created by parents before stock is given to their children, to be held subject to the provisions of the buy-sell agreement.

If a shareholder's involuntary termination of employment triggers the purchase of his or her stock, for example, the owners may very well wish to discount the value of the stock before it is purchased. Other owners may feel that the forced sale of the ex-employee's stock is sufficient penalty, without also discounting the stock value.

What if the buy-sell agreement is triggered because an owner simply retires on favorable terms with the remaining owners? What if an owner dies or becomes permanently disabled? What if a shareholder were to divorce and stock is to be acquired from an ex-spouse? What if stock is to be acquired from an owner's creditors?

If an owner were unexpectedly to die of a heart attack, for example, should not his widow receive full value for his stock? But if he was fired from the business for the disclosure of confidential information to a competitor, on the other hand, would not the other owners prefer to pay only a discounted price?

It is difficult to say under which circumstances the value of the purchased stock *should* be discounted. I recommend that the owners of the family business think through these alternative scenarios and make a conscious decision about valuation discounts in each case. Based on the nature of the business, the owners' financial circumstances and the history of their working relationship, what valuation methodology and discounts are reasonable and fair to all the owners and their families in each instance of a triggering event?

The agreement can specify for each triggering event whether the seller is to obtain an undiscounted price or a discounted price. The answer to this question (discount or not) does not need to be the same for each triggering event; indeed, the agreement can specify those events

which will result in the seller receiving a discounted price and those events which will result in the seller receiving full value without discounts.

Does the *same* valuation discount apply in every circumstance under the existing buy-sell agreement? Should the stock be discounted in *every* circumstance? Probably not.

Transfers incident to a divorce

Many buy-sell agreements provide that any stock awarded as part of a property settlement agreement to a divorced spouse of a shareholder is to be purchased. Many owners of a family business do not want an ownership interest to pass to an ex-spouse.

*But who buys the stock?* If the "normal" buy-sell provisions apply, the stock typically will be purchased by the business itself or by all the shareholders.

What about the shareholder who just went through a divorce? Should not he or she have the first opportunity to purchase the shares which the divorce court has awarded to the former spouse (over time with interest) before the business or other owners buy the stock?

It is bad enough to go through a divorce without also finding that your co-owners just bought half of your stock from your ex-wife or your ex-husband! Does the existing buy-sell agreement provide for this opportunity or does it merely state that divorce triggers the normal buy-sell provisions?

I recommend that the buy-sell agreement provide a first option to the divorcing owner, for a limited period of time, to purchase any ownership interest awarded to an ex-spouse, with the business or the other owners to have an option only if the divorcing shareholder fails to exercise his or her first option.

In community property states, I recommend that the spouses of all shareholders sign a consent to be bound by the terms of the buy-sell agreement while the relationship is still amicable. This consent will help minimize any argument that the stock awarded the ex-spouse is her community property.

Transfers to spouses

A common provision in many buy-sell agreements prevents transfers to a spouse of an owner, either during lifetime or at death.[10] Once again, many owners of a closely held business want to work only with each other (or with their children), but do not want spouses to become owners. This may be a result of spouses who are active in other businesses or professions, who have never worked in the operating family business or for a myriad of other reasons.

The consequence of a provision which prohibits transfers to a spouse is the denial of a

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10 If you are in a community property state, I recommend the spouse consent to be bound by the terms of the buy-sell agreement, so as to minimize any argument that the spouse has additional rights due to the interest of the shareholder somehow being community property.

marital deduction when any owner of the business dies.

That is, the owner cannot transfer an ownership interest to his or her spouse; therefore, the stock can only be left to a credit shelter trust or given to descendants as permissible transferees when the owner dies. This prohibition on transfers to or for the benefit of spouse will accelerate the payment of death tax which could have been delayed until the subsequent death of the surviving spouse if a marital transfer had been permitted by the buy-sell agreement.

To eliminate this problem, the agreement could permit transfers to an irrevocable QTIP trust for the benefit of the surviving spouse when an owner dies. The ownership interest is not given *outright* to the surviving spouse; rather, it is placed *in trust* for the lifetime benefit of the surviving spouse.

To qualify for the federal estate tax marital deduction, the surviving spouse must receive all the net income earned by the trust assets for life, no one else can be a beneficiary during the lifetime of the surviving spouse and the personal representative of the deceased owner's estate must file the necessary election with the federal estate tax return.

The spouse must be given the power to force the trustee to make the trust assets income producing, however, which may be troublesome if those assets consist of stock in a family business which has never declared a dividend.

I recommend that this irrevocable QTIP trust be permitted by the buy-sell agreement *so long as* (1) the beneficiaries who will receive the ownership interest upon the subsequent death of the surviving spouse are permissible transferees (such as descendants of the deceased owner), (2) no discretionary distributions of stock may be made to the surviving spouse and (3) the trustee of the trust is himself or herself a permissible transferee (such as a descendant of the owner, for example) or is a corporate fiduciary.

The deceased owner could thereby delay until the subsequent death of the surviving spouse any federal estate tax levied upon the value of the ownership interest. Because of our ever changing death tax systems, at both the federal and state levels, I recommend that you put off as long as possible the imposition of any death tax. Why pay deferrable tax when the family business owner dies?

## Lifetime transfers of an ownership interest

Some owners of a business only want to work with each other. Transfers to children and spouses are prohibited. The agreement requires the company or the surviving owners to purchase the stock of an owner who leaves the business during his lifetime or at death.

This restriction, however, prevents an owner from shifting future appreciation to his or her children by lifetime gifts. If lifetime gifts to descendants are prohibited, the owner must retain ownership until he dies, at which time the full date of death vale (including years of appreciation) will be subject to taxation.

If lifetime gifts to children or grandchildren were permitted by the buy-sell agreement, on

the other hand, an owner could give minority interests to his descendants (taking advantage of valuation discounts) and could shift to them any post-gift appreciation in the value of the gifted ownership interests. That appreciation will not later be subject to tax when the donor later dies because he or she no longer owned those shares.

To meet the goals of the business owners, the buy-sell agreement could permit lifetime gifts to children (or to trusts for their benefit), *so long as* the transferee must agree to sell the stock to the business or to the other owners upon the death of the donor. That is, the recipient of the stock (either outright or in trust) takes the shares subject to the buy-sell agreement, which requires the transferee to sell the stock when the donor dies.

## Gifts in Trust

Many buy-sell agreements permit shareholders to give stock to other family members. Gifts to trusts for minor children may be permitted. Does the agreement put any limitation on who can serve as trustee, however?

Suppose an owner's employment was terminated involuntarily. He wants the company to purchase his stock, but the business (and other owners) sees no reason to purchase his shares. He is a minority owner and will have no say in the management of the business. Why should they use scarce resources to buy his stock? Let him stay as a minority owner, they say (there is no purchase required by the buy-sell agreement in this case).

In order to gain some leverage at the bargaining table, suppose the disgruntled shareholder were to put his stock in a trust for his children (which was permitted under the buy-sell agreement) and named as trustee the company's strongest competitor? This trustee/competitor would then be a legal shareholder who would be entitled to a great deal of otherwise confidential information about the business! The business might suddenly be forced to purchase the shares, whether or not it wanted to do so or could even afford to do so.

Why not simply provide in the buy-sell agreement that the trustee must also be a permitted shareholder himself or must be a corporate fiduciary?

## There is no mechanism to keep ownership within cousin groups

When ownership passes to the third generation, cousins frequently will become owners of the business. If an event occurs which triggers the purchase of an owner's stock, who buys the stock?

You may represent, for example, the daughter of farming parents; she owns an undivided half interest in the family farm, while her brother (who is not your client) owns the other half interest. You work with your client to recommend lifetime gifts to her own children (grandchildren of the farming parents), so as to pass future appreciation to the third generation.

What happens if one of the grandchildren were later to file for divorce and his or her stock is purchased under the buy sell agreement? *Who buys the stock?*

If the agreement merely provides that the business or *all* the other owners purchase the

stock in the event of a triggering event, the 50-50 ownership of each family will be altered. To avoid this problem, the agreement could give the first purchase option to the siblings of the selling shareholder, with the business and the other owners being able to purchase any shares not purchased by the siblings.

The restrictions on transfers of ownership interests are too severe

If transfers of ownership interests are too restrictive, it is possible that lifetime gifts will not qualify for the $13,000 exclusion on annual gifts. That is, the Internal Revenue Service may determine that, because of the transfer restrictions, there is no way in which the donee can realize any value for the gift, so it is not a gift of a *present interest* and the per donee exclusion is not available.[11]

The $13,000 exclusion is available only if the donee is able to *use* and *enjoy* the gifted asset presently. If the restrictions on the transfer of the gifted interest are too severe (stock can be sold only with the consent of all the other shareholders, for example), the risk is run that the IRS will assert that the donee has no legal ability to use and enjoy the property. Therefore, the annual exclusion would not be available and the gift will have, instead, utilized some of the donor's gift tax applicable exclusion amount.

The down payment on an installment purchase is not set forth in the buy-sell agreement

Many owners of a family business contemplate using a buy-sell agreement only when one of them dies. Life insurance may be acquired to fund the purchase of the deceased owner's stock.

But what if, as happens many times, the agreement is triggered due to an event that happens while the owners are very much alive? There will be no life insurance proceeds to pay for the ownership interest.

*Lifetime triggers*. The agreement should provide for the payment of the purchase price over a number of years, with interest, if the event which triggers the purchase occurs while the owner is living. Specify the percentage down payment which must be made when the installment obligation is executed. The down payment need not be the same for every lifetime triggering event, of course.

If the event which triggers the operation of the buy-sell agreement is the involuntary termination of employment, do not be too generous with the amount of this down payment. You do not want to finance the departing owner's new, competing business!

*Death of an owner*. If the ownership interest is purchased as a result of the owner's death, I recommend that the purchaser be obligated to pay the entire purchase price, in a lump sum, out of the insurance proceeds on the life of the deceased owner. If the purchase price exceeds the life insurance proceeds, require the balance to be paid in installments over time, with interest.

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11 See, for example, *Fisher*, 105 AFTR2d 2010-1347 (DC Ind., 2010).

But what if the insurance proceeds exceed the purchase price determined according to the buy-sell agreement? Many agreements are silent on this question. Does the purchase price go up to equal the amount of the insurance proceeds or does the beneficiary of the insurance policy keep the excess proceeds?

There is not a "right" answer to this question; however, the answer determined by the owners should be set forth in the buy-sell agreement.

<u>There is no discussion of the later sale of the business</u>

Suppose that an event has occurred which triggered the operation of the buy-sell agreement. The purchase price is being paid in installments, perhaps over fifteen years.

What happens if the remaining owners of the business decide to sell the business in year three of the fifteen year term of the promissory note, for a price which greatly exceeds the appraised value determined at the time of the triggering event?

There are two issues: (1) should the subsequent sale of the business accelerate the payments under the promissory note payable to the departed shareholder? and (2) should the subsequent sale of the business increase the amount payable to the departed shareholder? The buy-sell agreement should answer both of these questions.

It seems reasonable to provide for an acceleration of the amount payable to the departed shareholder if the business is sold before the purchase price has been paid in full. You should not be able to sell stock you haven't fully purchased, they assert.

It is less clear whether a subsequent sale of the business should also increase the amount payable to the departed owner. Was the later increased price the result of the work of the remaining owners, which should not be shared with someone who left many years earlier?

On the other hand, the buy-sell agreement could include a sliding scale, which mandates an increase of the amount payable to the departed shareholder, with the percentage increase declining with the passage of time after the triggering event and with the percentage increase going up as the disparity between the appraised value and the later sales price increases.

<u>The buy-sell agreement is not consistent with the estate plans of the owners</u>

As law firms increase in size, many lawyers begin to narrow the focus of their practice. Some general business attorneys may focus on transactions on behalf of their family business clients, while others may handle the estate planning concerns of those same business owners.

Estate planning attorneys may not be called upon to work on the business aspects of the entity, while the business lawyers may not be called upon to do estate planning work for their clients who own family businesses.

If the business and estate planning lawyers do not effectively communicate with each other, there is a risk that the provisions of the buy-sell agreement are inconsistent with the

provisions of the owners' estate plan and *vice versa*.

For example, an owner's estate plan may contemplate a marital transfer of the assets which exceed the applicable credit amount, while the buy-sell agreement prohibits transfers to any spouse of an owner. The estate planner may have recommended the use of lifetime gifts to take advantage of valuation discounts and to shift future appreciation to the children, while the buy-sell agreement may prohibit lifetime gifts.

In a similar fashion, the estate planning documents may name as trustee those who are prohibited from serving in that position by the buy-sell agreement. The estate plan may contemplate trusts which are not qualified Subchapter S trusts, thereby requiring them to become electing small business trusts.

The problem is a lack of communication and coordination between the business and the estate planning lawyers. It would be unfortunate that, due to these problems, either the business or the estate planning lawyer must go back to the family business owner to explain why a recommended strategy cannot be implemented.

It is far preferable for both lawyers to be aware of the work of the other. Are the transfer restrictions in the buy-sell agreement consistent with the gifts in the proposed estate or gift tax planning? Are the provisions in an existing estate plan consistent with a proposed buy-sell agreement?

## Discretionary Distributions to Children

Many owners of family businesses have heard stories about "perpetual students" and "trust babies." They want the assurance that their children will not be able to stay in college for years and years as a benevolent trustee pays room, board and tuition and they do not want their children to sit around the pool drinking margaritas while the same trustee willingly distributes principal to provide for their "maintenance and support."

The solution may be to include incentive provisions in the estate planning documents in the form of guidelines to the trustee. These guidelines can explain to the trustee the thinking of the business owner when he uses the terms "health, education, maintenance and support."

*Health* might be generally understood to mean that the trustee can help pay for those medical expenses which are not covered by insurance. However, if the beneficiary knows that the trustee will pay for his medical expenses, what incentive does this child have to purchase medical insurance? Therefore, the guidelines might ask the trustee to obtain annual proof of medical insurance from the beneficiary, with the trustee to buy out of the trust assets a medical insurance policy for the child if he refuses to do so himself.

*Education* can mean almost anything these days, as people go back to finish their degrees. But it can also mean that the trustee is expected to pay for whatever education the beneficiary wishes. To avoid the problem of "perpetual students," the guidelines could specify that the trustee is only to pay for a set number of years (say, five) for undergraduate education. If a beneficiary stays longer than that in college, he must pay for the expense himself.

If the trust benefits more than one child and if the assets are not substantial, there is the risk that the oldest child might deplete the entire fund if he or she attended an elite (i.e., expensive) college or university. To prevent the trustee from inadvertently using most of the trust assets to educate one child, the guidelines could provide that the trustee can pay only what would have been paid had the child attended a specific state university where the parent resides; if the child attends a more expensive institution, he or she must pay the excess cost himself or herself, through scholarships, student loans and part-time employment.

Remember that these are merely guidelines for the trustee. The business owner is saying to the trustee to follow these guidelines in a "perfect world." If unforeseen medical problems were to arise, for example, making the completion of a college education within the stated time impossible, the trustee has the flexibility to extend the guidelines.

*Maintenance and Support* can mean virtually anything. It is difficult to imagine a beneficiary's need for money which cannot somehow be construed as being for his or her maintenance and support. In order to avoid the "trust baby" phenomena, the guidelines could provide that the trustee can only distribute an amount equal to[12] the beneficiary's earned income from the prior year for his "maintenance and support" after the beneficiary reaches a stated age, such as twenty-one.

Some estate planning instruments contemplate the trustee's discretionary distribution of principal to enable the beneficiary to buy a home or to start a business. I have had experience with beneficiaries in their early 20s who expect the trustee to buy a home for them comparable to the home they grew up in. The guidelines could provide that the maximum amount which the trustee can distribute for each of these purposes is equal to the amount invested by the beneficiary.[13] If the beneficiary has his or her own money invested in a new business (and not just money from a parent's trust), I can almost guarantee you that the child's personal commitment to the success of this venture will rise dramatically!

Once again, these are merely guidelines. If the beneficiary were to become incapacitated or were to engage is a "socially useful, but underpaid profession" (such as an elementary school teacher or charitable worker), the trustee can exceed the guidelines. Care should be given when drafting these guidelines to ensure that the trustee will take into consideration the earning capacity of beneficiary's spouse. The business owner will not want the husband of his married daughter to stop working and to live off the trust merely because she is an elementary school teacher.

*Guidelines about when scheduled distributions should be postponed.* Some business owners want the assurance that the business will stay in the family. They know of today's divorce rate and are worried that some equity in the family business will end up in the hands of an ex-spouse.

It is possible to include a specific provision (not a guideline, but a requirement) that any scheduled distribution is to be delayed for a set number of years (say, ten years) if the beneficiary marries prior to the scheduled distribution without a prenuptial agreement in place which will

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12 A larger multiple can be selected, of course.

13 Once again, a larger multiple can be selected.

insure the business' staying in the owner's family. A provision of this sort may actually be useful to the child who is about to get married, as he or she can blame the need for the prenuptial agreement on their father!

Because prenuptial agreements can later be set aside for any number of reasons, you might go on to require the spouse of the child to execute a written, irrevocable disclaimer of the assets which are about to be distributed to the child and, failing that, the distribution is postponed or never made.

Other, more discretionary, provisions can be included to provide additional guidance to the trustee. The estate planning documents, for example, might permit the trustee to delay indefinitely any scheduled distributions if the beneficiary is not engaged in "productive activities." Examples of the business owner's thinking must be included, of course, such as (1) the child's failure to pursue an education in order to obtain meaningful employment; (2) the child's refusal to support himself in a manner commensurate with his abilities; (3) the child's abuse of drugs or alcohol; and (4) the distribution will only be taken by the child's creditors in payment of unreasonable liabilities he has incurred. The instrument must release the trustee of any liability the trustee may have as a result of the exercise or non-exercise of these discretionary powers, with the trustee to be indemnified by the trust assets.

## Name a "Family Protector" Who Can Change the Plan

When estate planners work with family business owners and consideration is given to the age or ages, at which an ownership interest in the business is to be distributed to the children, we are merely making educated guesses about what the future may hold. We have no idea whether the children will, in fact, be mature enough to "handle" the inheritance at the ages which appear in the estate planning documents.

It is possible to name an independent third person to serve as a "Trust Protector," who can actually direct the trustee to withhold or to accelerate scheduled distributions based on the facts and circumstances which exist in the future. Once again, the estate planning documents must expressly relieve the Trust Protector from any liability he or she may have as a result of the exercise or non-exercise of these discretionary powers and the Trust Protector should be indemnified by the trust assets.

Examples of the usefulness of a Trust Protector include the five year delay in the scheduled distribution to a young woman, whose husband was ready to file for divorce the next day. He wanted half of the distribution to go to him as part of the property settlement. Another example is the young man who was scheduled to receive $300,000 on his 25th birthday; unfortunately, he was a drug addict. The Trust Protector (who was identified as whoever was the senior priest in the business owner's parish) refused to give him the money and checked the child into rehab.

Anything we can do to increase the flexibility of the estate plans we create is a good thing.

## Tax Charging Clauses

This little clause, infrequently reviewed, may cause untold problems for the estate planner. Too many advisors have a standard tax charging clause, which might have been developed years before, which is routinely used in all their estate planning documents. Pay all death taxes out of residue. That is what everyone wants. Right?

There are several reasons why the unilateral use of the typical tax charging clause, which imposes that burden on the residuary estate, may cause problems.

*Non-probate transfers*. Many clients today are planning to pass assets to the objects of their bounty using many different strategies, including jointly held property, POD accounts, beneficiary designations on investment accounts, revocable trust agreements, life insurance beneficiary designations, annuities, retirement accounts, irrevocable life insurance trusts and so forth.

Are the beneficiaries who receive these non-probate assets the same as the residuary beneficiaries under the will? If so, it may not make much difference if the tax liability is imposed on the residuary estate, as the dollars all come from the same beneficiaries *and in the same proportions as the non-probate transfers*.

But if some or all of the non-probate assets pass to beneficiaries who are not beneficiaries under the will's residuary clause, those residuary beneficiaries will find themselves paying the death taxes generated by assets which pass to other people if the entire tax liability falls on the residuary estate. They will not be happy with the estate planner who came up with this result, especially if there is no evidence that the tax charging clause and its consequences were discussed with the decedent.

*The large specific bequest.* Some estate plans include a large specific bequest which precedes the will's residuary clause. The business owner, for example, might want a specific gift of his business interest to that child who works with him and, to equalize, wants all his remaining assets to go to the non-business child.

The specific gift of the business interest will be free of any death tax liability and the non-business child will be expected to pay all the death taxes if the typical tax charging clause is used.

It seems reasonable to expect the estate planner to consider the taxes which might be generated by non-probate transfers and large specific bequests and to have the client make a specific decision about who pays the tax liability.

*Generation-skipping tax considerations* may also come into play when the estate planner is writing the will or revocable trust agreement which creates a QTIP generation-skipping trust. If a reverse QTIP election is made when the first spouse dies, there may be a QTIP trust which is wholly exempt from generation-skipping tax and a second QTIP trust which will be subject to generation-skipping tax. Both the exempt and the non-exempt QTIP trust will be subject to

federal estate tax at the subsequent death of the surviving spouse.

The planner should provide in the estate plan of the spouse who dies first that any tax liability resulting from the QTIP assets at the subsequent death of the surviving spouse must be satisfied first out of the non-exempt QTIP trust, so as to maximize the assets which remain in the QTIP trust which is exempt from generation-skipping tax.

If that language does not appear in the document which creates the first spouse's QTIP trust, there is some question whether the will of the surviving spouse can provide for the payment of that liability first from the non-exempt QTIP trust. Code Section 2207A(a)(2) provides that the surviving spouse can waive the right to recover the additional estate tax generated by the QTIP trust assets; however, it does not expressly grant to the surviving spouse the power to direct how that tax liability is to be allocated within the QTIP trust itself.

Therefore, the preferred approach is to have in the document which creates the QTIP trust language which requires the additional estate tax payable at the death of the surviving spouse to be paid first from the non-exempt QTIP trust.

The Direction to Retain the Business Ownership Interest

The Prudent Investor Rule in most states would require a trustee to liquidate any family business interest which is held in trust. Not only is the investment speculative, it almost always represents the most significant holding in the trust. We all know that putting all your eggs in one basket, let alone a speculative one, is not prudent.

Nevertheless, the business owner typically does not want the trustee to sell the stock. Neither do the beneficiaries. However, a disgruntled child later could seek recovery against the trustee for his failure to sell the family business interest which is held in trust.

To avoid this problem for the trustee and to accomplish the business owner's objectives, the estate planning documents should override the normal prudent investor obligations of the trustee. The will or trust agreement should *require* the trustee to retain the ownership interest in the family business unless the trustee is directed in writing by specified beneficiaries to sell it.

I recommend that you not mandate the forever retention of the business interest in the estate planning documents. Who knows what wonderful buy-out offer might come some day, long after your client has died?

Rather, I recommend that the language refer specifically to the holding by name, provide that the direction applies to any successor business and gives to one or more of the beneficiaries the power to direct the trustee's sale of the investment.

Language which merely gives the trustee the power to retain the original trust assets is not sufficient to relieve the trustee of this obligation to sell the business interest. The power to retain necessarily includes the power to sell. The wording should provide that the trustee *must retain* the business holding *unless* directed in writing by named beneficiaries to sell it.

The trust instrument should go on to relieve the trustee of any liability which the trustee

might have as a result of the retention of this investment.

<u>There is no process to resolve deadlocks short of court</u>

If there were a disagreement among the family business owners, what (if any) mechanism exists to resolve the dispute short of litigation?

In the absence of a provision in the buy-sell agreement which mandates mediation or arbitration, owners who have significant differences can only resolve those issues through litigation. How comfortable are they leaving the resolution of these business issues up to a local judge? How much of their resources will be spent on legal fees and other expenses?

The buy-sell agreement could (and probably should) mandate mediation or even binding arbitration in an effort to resolve any disagreement among the owners short of lawsuits.

<u>There is no provision to adjust the purchase price to the final tax value</u>

If an ownership interest is purchased due to the death of the shareholder, his or her estate will seek to use the purchase price as the value of the stock for federal estate tax purposes. What happens, however, if the estate tax return is selected for audit and, after an examination or even trial, the value of the ownership interest is increased above the purchase price paid?

Must the purchaser of the ownership interest pay the difference between the final federal estate tax value and the price initially paid? If there is no obligation to do so in the buy-sell agreement, what impact does that have on the estate of the deceased business owner?

If the purchaser is *not* obligated to increase the purchase price to equal the final federal estate tax value of the ownership interest, the gift of that ownership interest to a surviving spouse may not qualify for the marital deduction. If the ownership interest (or the proceeds of its sale) are given to the surviving spouse or to a marital trust, the purchaser's legal right under the buy-sell agreement to purchase the ownership interest for a price which is less than its fair market value may jeopardize the marital deduction.

A marital deduction may be permitted only for the purchase price actually paid. Any additional final federal estate tax value, not received by the surviving spouse, would not qualify for the marital deduction because the surviving spouse or marital trust never received that value.

If the purchase price determined in accordance with the buy-sell agreement is not accepted by the taxing authorities, the agreement should require the purchaser to increase the price paid to equal the final federal estate tax value of the ownership interest.

<u>There is no Subchapter S protection</u>

S corporations with buy-sell agreements should be certain that transfers to non-qualified shareholders are prohibited, that permissible transferees must consent to the continued S election and that any transferee trusts are either qualified Subchapter S trusts or electing small business trusts.

In the absence of those provisions, any unhappy owner might be able to terminate the S election by transferring stock to a non-qualified shareholder.

## Ask Another Lawyer to Review Your "New" Language

Clients often have specific requests which lead the estate planner to vary from his or her "standard" language. We actually have to come up with some new wording to accomplish our client's wishes!

I recommend that you always have another lawyer review this new language without telling him or her what the provision is supposed to say. Ask the other lawyer to read what you have written and to explain what the other lawyer thinks it means. You may be surprised at how often the answer is not exactly what you or the client intended.

The problem is that we know what the new language is supposed to mean and we believe that the words we have written accomplish that objective. But we know what this provision is supposed to mean! Have someone read it who does not know what it is supposed to mean and see if his or her interpretation is consistent with your client's wishes.

Recall that most of these plans will some day be implemented by fiduciaries who did not attend the meeting between the client and the estate planner and do not know what the new language is supposed to mean; rather, they are left to figure out the documents on their own. That is why the input from another lawyer, who does not know what the answer is supposed to be, can be very helpful.

## So what advice do we give our clients?

Most owners of family businesses seek the advice of their lawyers only as a last resort. They have been sued or they are engaged in a significant transaction. Lawyers are a necessary evil and, if there is not an immediate crisis, our services may not be requested.

However, many family business owners need more legal assistance then they are willing to admit. What liability do we – the advisors to these family business owners – assume *if we fail to advise them even if they have not asked us to do so?*

If you have represented the owners of a family business for years and years, is it reasonable for them to expect that you will advise them on the business succession strategies which are required to assist in the successful transition of ownership to the next generation? If you fail to provide that expected advice (whether or not they conveyed their need for it to you!), what professional liability have you assumed?

The update of an old, out-of-date buy-sell agreement may be only the tip of the iceberg. What successor management is in place? What additional new training is required of these new managers? What Board of Directors' oversight should be put in place?

It is not sufficient for the family business attorney to exclaim after the fact that "The business owner never asked me to consider these issues!" We need to be more insistent that our

clients do the work which is required to pass the family business on – successfully – to the next generation.

## The problem of too many advisors

Most owners of a family business have many advisors, including a lawyer, an accountant, a financial planner, a bank lender, an insurance professional and so forth. There is frequently insufficient coordination among these advisors.

We all are talking independently with the family business owner, giving him great ideas; unfortunately, we are not talking to each other. The advice we give may be inconsistent and, perhaps, incomplete because each advisor fails to take into consideration the unique perspective and expertise of the other advisors.

If the lawyer recommends an updated business succession and estate plan for the family business owners, it is not unusual for them to consult with one or more of their other advisors before proceeding.

How conversant are these other advisors in these issues? The risk we run is that one or more of the other advisors may not understand what the client is talking about. Rather than admit they do not understand, they may tell their own good clients that "You don't need that."

I have found that this phrase is code for "I don't get it." They cannot admit to the family business owners that he or she is not up to date on the intricacies of business succession and estate planning. Rather, they shoot holes through the recommendations.

It is critical that you find out the identity of these other advisors. Who else is on the team? Get them involved in the entire family business succession and estate planning process.

I recommend that you have a meeting of all the advisors *without* the family business owners present. The advisors should consider all the issues presented by the business, the owners, the tax laws and so forth, in an effort to develop a comprehensive strategy for the clients.

If the business owners were present at this "brainstorming" session, there may often be a lot of grandstanding by the advisors. If the family business owners are not there, on the other hand, a lot of that posturing seems to go away.

Of course, the clients must pay for the advisors' work at this initial meeting; however, it may be the most productive use of their fee dollars that the business has ever spent!

## Conclusions

One of our most challenging goals is simply to get the family business owner to start on his or her own estate and family business succession planning. This is not easy. We ask them to confront their own mortality, to decide which child will be the new manager, to deal with the guilt of not naming another child and so forth. They prefer to put this off.

If you can sit down with a client and discuss some of the issues raised in this material, you just might get the family business owner's attention. Have the spouse sit in on your meeting – he or she may be the most effective motivator!

These are real issues which must be dealt with by real people. It is our obligation to urge our clients to engage in this critically important work. It is too easy for business owners to adopt the Scarlet O'Hara approach to estate and business succession planning ("I will worry about that tomorrow, for tomorrow is another day!").

Our ethical requirement is to provide our clients with "competent representation."[14] For business owners we have represented for years, it is reasonable to conclude that estate and business succession planning are part and parcel of this competent representation we are expected to provide.

We each need to document for our files the continuing efforts we make to encourage our business owner clients to engage in this work. Too often the advice is oral and there is no record of the conversation in the lawyer's file. When the business owner dies without doing this work and the disaster you warned of becomes real, how can you convince the unhappy family that you had tried to get their father to engage in the strategies which they now (with 20-20 hindsight) understand could have prevented the problems.

Working with family business owners can be very rewarding. There are complex interplays of business, family, tax and emotional issues. No plan exactly replicates another because of the wonderful human elements with which we deal. But that is exactly what makes it fun!

Acknowledgement of Self-Dealing and Conflict of Interest and Waiver

It is my belief that the interests of all beneficiaries under this Will and of any trust created under my Will, including all life beneficiaries and remaindermen, will be best served by the Personal Representative and Trustee having the powers granted herein. I have named the people who will be called upon to serve as those fiduciaries after taking into consideration the best interests of the beneficiaries, based on broad issues, including the beneficiaries' emotional, financial, social and other intangible interests, and my belief that those fiduciaries will act fairly.

I acknowledge that the person or people who, from time to time, may be serving as Personal Representative and Trustee under this Will may exercise powers in which they will be individually interested and that they may as a result directly or indirectly benefit therefrom.

No fiduciary acting as Personal Representative or as Trustee shall exercise the powers of a fiduciary in a manner which would result in that individual having a general power of appointment, as that term is defined in the Internal Revenue Code of 1986, as amended, and its Regulations.

I fully authorize any individual Personal Representative and Trustee to act with respect to any matters in which a fiduciary may be individually interested, in spite of any self-dealing

14 Rule 1.4 of the Model Rules of Professional Conduct.

prohibition, or the resolution of which is in some respects adverse to the short-term interests of some beneficiaries, and the actions taken in these respects, shall be as binding and conclusive as though no relationship or conflict of interest existed.

I hereby exonerate and hold harmless any Personal Representative or Trustee who takes action as a fiduciary in accordance with these provisions and that fiduciary shall be held harmless from any liability for his or her actions in a fiduciary capacity, absent a judicial determination that the Personal Representative or Trustee placed his or her own interests above those of the estate or the trust.

The Trustee may not take any action under this provision or be in any way limited which would in any way jeopardize any Federal or state estate tax marital deduction for property passing at my death and nothing herein shall contravene my spouse's rights with regard to unproductive property held in the Marital Trust.

The foregoing provisions apply only to all of the individuals I have named as fiduciaries in this Will and shall not apply to any successor fiduciaries not specifically named in this Will who may serve from time to time.

Powers of the Business Advisor

In the event that the Trust Property consists of an interest in a closely held business, the Trustee shall follow the written direction of ______________________________ (the "Business Advisor") with respect to the direction and management of this asset, subject to the following limitations.

The Trustee shall be relieved of liability for following the direction of the Business Advisor, including the decision of the Business Advisor to take no particular action with respect to the closely-held business. The Business Advisor may be removed from the office of Business Advisor by the majority vote of those beneficiaries of the trust created hereunder which owns the interest in the closely-held business who are then eligible or entitled to receive distributions of net income from the trust, who may (but are not required to) name a successor Business Advisor. The Business Advisor may resign from the office of Business Advisor by written notice to the Trustee and to those beneficiaries who, under the prior sentence, had the power to remove the Business Advisor from that office at that time. If there is any time when no Business Advisor is serving in that office, the Trustee shall assume full fiduciary responsibility for the closely-held business interest held in trust hereunder.

The Business Advisor shall exercise the powers herein granted to the Business Advisor in a fiduciary capacity.

The Business Advisor shall have the power to change forms of business entity, to continue the business, to retain net earnings for working capital of the business, to make or consent to various tax elections with respect to the business interest and to exercise those additional powers which the Business Advisor, in the reasonable discretion of the Business Advisor, believes are necessary to fulfill the fiduciary responsibilities of the Business Advisor.

If the closely-held business is operated as a sole proprietorship, the Trustee shall treat the

business as a separate entity from other trust assets and shall account for the business interest in accordance with standard accounting practices. The Trustee shall have the power to change the sole proprietorship to a corporation, limited liability company, partnership or other separate entity.

If the Business Advisor requests that the Trustee invest other trust principal in the business, to loan other trust principal to the business or to pledge other trust principal as collateral for loans to the business, the Trustee shall grant that request without question or liability if and only if the Trustee owns one hundred percent (100%) of the closely-held business. If the Trustee owns less than one hundred percent (100%) of the closely-held business, the Trustee shall grant that request and shall be relieved of liability if and only if the Trustee receives, in advance, the unanimous written approval of those beneficiaries who are then entitled or eligible to receive the trust's net income and the written approval of a majority of those beneficiaries who would be entitled to receive the principal of the trust were it to terminate at that time.

The Business Advisor shall receive reasonable compensation for the services which are provided, payable equally from trust income and trust principal; however, that compensation shall not be payable from trust income and trust principal if the Trustee believes the compensation received by the Business Advisor from the closely-held business itself is reasonable compensation for the services also rendered by the Business Advisor to the trust."

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