THE LIMINAL
GROUP

ESTATE PLANNING & BUSINESS SUCCESSION:

Transfers of a Closely Held Business to Family

Business Succession Planning

Nathan Brinkman

Nathan Brinkman • nathan@theliminalgroup.com
theliminalgroup.com • 608-828-4404

Transferring a family-owned business to a future generation of owners can involve some complex estate planning issues depending upon the value of the business. The state and federal taxman may have an interest in any estate, gift, or capital gains taxes that may result from the transfer. The second section of this article provides an overview of a handful of estate planning techniques to transfer businesses.

Perhaps more important than the legal and financial details of transferring a business to a future generation is the concern of who will run the business and the relationship between siblings as a result of the transfer. Parents and children often have vastly different perspectives on the children becoming the next generation of business owner(s). Some children readily see the business as their family legacy and relish the opportunity to continue its growth. Others view it as a family legacy that they are honor-bound but not excited to inherit. Still, others see it as an asset to be sold as soon as the parents are deceased to provide the capital to pursue the children's true career objectives.

Nathan Brinkman
President and Founder
nathan@theliminalgroup.com

theliminalgroup.com
608-828-4404

Business Succession Planning

A Client once invited me to a special gathering in which he was celebrating the one-hundredth anniversary of the family business. There were current and former employees as well as many different generations of family members in attendance. As the party started winding down, he approached me and said he wanted me to help him with a goal of his. He wanted there to be a two-hundredth celebration. Their business had prospered and had survived the transition through multiple generations, so they had already beaten the odds.

According to the US Small Business Administration, 70 percent of family-owned businesses fail to survive a transfer to the second generation, and only 12 percent survive a transfer to the third generation. Given those odds, two hundred years seems highly unlikely. But given their past success, and their acceptance of the fact that it takes careful planning to achieve his goal (it won't just happen), it was an exciting project to be involved with.

> ... it is more often than not the relationship issues, emotional issues, and communication issues that are the biggest impediments.

There are countless reasons why families have difficulties successfully transitioning the family business from one generation to another. Advisors will often attempt to tackle the tax, financial, and legal issues, but in my experience, it is more often than not the relationship issues, emotional issues, and communication issues that are the biggest impediments. A quick glance at the newspaper headlines is all it takes to realize that keeping the business in the family presents unique challenges.

Before going any further, I feel compelled to share what my experience has been with families that pass on business interests to multiple children. I cannot tell you how many times I have had a discussion with a parent/business owner who 100 percent assured me that his children want to take over the business and followed that up with a discussion with the children who assured me they 100 percent did not. And, as could be expected, I have had numerous dealings with children who took over the family business only to regret it and attempt to sell the business within a few short years.

So why the confusion within the family? Why is it that I am hearing things the parents are not? Here is my take on what is occurring. Parents spend a lifetime creating, expanding, living, and breathing the business that they or their parents founded. It's talked about at family dinners, it's talked about on vacations, and it's part of the family dynamic like sugar in sweet tea. Then one day, they are asked if they want to be involved in the family business. That's like Babe Ruth asking his son if he wants to play catch.

They almost always say yes, but not necessarily because it was their lifelong dream to run the family business. Some expressed to me that they felt pressured, like it was expected of them, or simply didn't want to let their parents down. But when the reality of business ownership hit them on a daily basis, they decided they would much rather have the sales proceeds. So before moving forward, parents should always make sure they are getting an honest answer from their children as it relates to taking over the family business.

THE LIMINAL GROUP

Later in this article, I will discuss several strategies that are commonly used to transfer the family business to the next generation. These are well-established concepts that help to minimize gift and estate taxes, protect business interests from attack from creditors, etc.

But first, I wanted to provide you with a few ideas that have more to do with avoiding family strife than gaining tax and legal advantages.

1. Take the time to strongly consider the strengths and weaknesses of those family members you wish to transfer the business to. Giving equal rights in ownership to individuals who have different talents may backfire. One concept that has worked very well for certain families is to separate the business into different entities and transfer the entities to the individuals who have the skill sets and desire to make that particular business successful. In some cases, you may even want to consider passing on the current business to one of your adult children and creating a new separate business for a different child. These businesses may interact with each other and they may have legal agreements between them.

   The key is that the businesses should be able to stand on their own. This avoids a lot of the potential issues and stress that can arise when children own the same entity yet one disagrees with decisions the other is making. I have seen owners pass on ownership in the family business and attempt to put different children in charge of different divisions within the same business. However, each of their financial interests is still tied to the same business, so this may have little effect on reducing disagreements and the feeling they may have of being trapped.

   Here is a good example of how breaking a business into separate entities worked for one client. John owned a business that manufactured and sold carpeting. He had two sons, Brian and James. Since he was a young boy, Brian loved to help his father install carpets. He was a hands-on craftsman who was also very creative. He had no real desire for college or higher education. James was more of an academic. When he went to job sites with his father as a teenager, he spent half his time sulking and the other half carrying supplies (because he was dangerous with a hammer). He took advanced courses in high school, was accepted to a prestigious university, and had an interest in the business end of what his father did.

Having a business succession plan that transferred ownership equally to both sons would have generated predictable issues that would most likely have caused the business to terminate. Instead, when the time was right and both sons were ready, John decided on the following plan: he gifted half of the manufacturing and retail business to James and sold him the other half in an installment sale. John used a portion of the income from the sale and invested in a new carpet installation business that Brian would own. The two brothers and their father worked on structuring an agreement whereby the installation business would provide services for clients of the manufacturing business on terms they could all agree on. The key to the success of this plan is that both businesses operated independently of each other and could stand on their own. James did not have to be concerned with running an installation operation that he knew nothing about, and Brian did not have to deal with inventory, manufacturing, shipping, etc. James could now grow the manufacturing business as he saw fit without having a partner/brother to pass things by, and Brian could do the same.

2. Practice makes perfect, or so the saying goes. Before transferring ownership in the family business, it is always a good idea to give a family member some real management and decision-making authority. These can’t be small, insignificant decisions where you jump in to save them if they falter. Let them fail, let them succeed, but most importantly, let them know what it feels like to have family members, employees, employee families, suppliers, wholesalers, etc., rely on their ability to make wise decisions. Let them lose a little sleep and see if they have the personality to thrive in such situations. Let them know that this is not simply a test to determine if they have the required skill sets to take over the family business. It is also a test to see if they want to take over the family business. When done correctly, this will strengthen family bonds.

3. Winston Churchill once said, “When you are winning a war, almost everything that happens can be claimed to be right and wise.” In other words, when you are winning, even though you may have made a poor choice, it seems like it was a wise choice. With this in mind, regardless of whether you are planning to transfer your business to the next generation during your life or after you pass, make sure you set your children up for some initial success. And if possible, do so while making it seem like it was their success, not your help.

One of the worst things that can happen after a transition is for there to be negativity in the workplace. If sales go down, if employees leave, if contracts are lost, if employees have concerns over being laid off, if the new owners stumble with tasks the old owner made look routine, then the family members who took over will feel immediate pressure they may not be able to handle. They will tend to make snap decisions that aren’t well thought out, productivity will go down, lenders and suppliers will get concerned, rumors will fly, etc. So, do what you can to ensure there are successes after the transition.

4. Business owners constantly remark, “Cash is king.” Cash can help take advantage of new opportunities, cash can help a business remain afloat during a downturn in business, cash can give you an advantage over competitors, cash can help get rid of bad debt obligations, etc. A golden rule for a successful transfer of a family business to the next generation is to never pass on the business without passing on cash. This can be done in several ways. You may forego dividend distributions for several years prior to transferring the business, have the business purchase life insurance on you so it is infused with cash upon your passing, enter a sale-leaseback agreement (in which you sell the real estate that the business is located on) and enter a long-term lease agreement with the buyer.

Succession

Valuation

Liquidity

Succession, valuation, and liquidity are key estate planning issues for the family business owner. The business may be the most valuable asset in the owner's estate. If you own a business, you should address the following concerns as you plan your estate:
Keep in mind that tax laws have been drafted to distinguish between a bona fide business arrangement and schemes that attempt to put form over substance. For example, a buy-sell agreement that transfers stock to family members at below-market values will be disregarded for purposes of determining the value of the stock for estate or gift tax purposes.

Transfers of stock to family members during life for anything less than full consideration is a gift and would require a gift tax return if the value of the gift exceeds the available annual exclusion. Whether or not a gift tax return is due, it is important to substantiate the value of the gift with the current valuation. If a gift tax return is required, the valuation should be attached to the return. Once the IRS accepts the appraised value for gift tax purposes, it cannot raise the valuation issue again for estate tax purposes.

Estate Tax Deferral

Another way to provide for the estate tax is to take advantage of tax law provisions for estates holding a closely held business. These provisions allow you to defer the estate tax attributable to your business, instead of paying on the normal due date, which is nine months after the date of death. Be aware, however, that the deferred payment alternative is available only if the value of your business exceeds 35 percent of your adjusted gross estate and that the statutory definition of "closely held business" is complex and narrowly drawn. Although the estate must pay interest at government-set rates throughout the deferral period, that rate may be as low as 2 percent in certain circumstances. Annual installment payments of the tax itself generally begin five years from the date of death and may exceed a ten years, with a myriad of special rules for special situations.

Leverage Through Discounting

The three most common ways a business interest is transferred are by sale, by gift, and by request. If the recipient is a family member, you may desire to have the value of the business be as low as possible to minimize gift and estate tax exposure. The IRS is well aware of this and is keenly aware that the valuation parents claim when they transfer a business (or any asset of substantial wealth) may be lower than fair-market value. One way to reduce the value of a transferred asset that has the blessing of the IRS (when done within reason) is to take advantage of marketability and minority interest discounts. This may be done in several different ways, but the two most common are *family limited partnerships* and *recapitalizing corporate stock.*

Family Limited Partnership

FLP—Transfer the business to a family limited partnership in exchange for all the general partnership interests and limited partnership interests (nontaxable event). Retain the general partnership interests (and therefore control), and gift, sell or bequeath the limited partnership interests. The value of the limited partnership interests will be discounted (by as much as 20-30 percent).

Recapitalize Corporate Stock

Recapitalize stock into voting and nonvoting shares (does not violate the "one class of stock" rule for S corps) and gift the nonvoting shares to family members. Similar to the limited FLP interests, the value of the nonvoting stock may be discounted by as much as 30 percent.

At this point, I think a **real-life example** would be beneficial. Jim Simon has a successful surgical-products distribution company as well as a wonderful wife and two happy children. As he got older, his son Mark began working in the company and eventually began managing the day-to-day activities, while his daughter Linda decided to pursue a different career path. A few years before Jim died, he wanted to make sure that Mark inherited the business, but at the same time, he wanted to be fair to Linda. So Jim did what many parents in similar circumstances have done. He inserted into his will a provision that read, "At the second death of my wife or myself, I leave the business to my son and assets of equal value to my daughter, and they are to split the rest of my estate equally."

This story should have a happy ending, with Mark running his father's business and being passed down the business and Linda receiving her share of the estate, giving her the opportunity to pursue her passions with better security. Unfortunately, Jim didn't anticipate the difficulty his passing instructions would cause. Mark and Linda spent years arguing over the valuation of the company, regarding Linda's equal value share of assets. The argument turned into a long, expensive legal fight, placed a strain on the family, drained profits from the firm, and consumed so much of Mark's attention that the company lost much of its value by the time the arguments were settled.

To some, this story may translate into one of greed, separate from their business and family. Unfortunately, it is as common and natural as two young children arguing over who got the bigger scoop of ice cream.

Jim's best intentions and pitfalls are not unique. There are numerous other well-intentioned ways of distributing assets that lead to conflicts:

1. Transferring stock to a child can mean that the stock could pass to the child's spouse in the event of death or divorce. This can be avoided through the use of a shareholder agreement when the stock is transferred, with the stipulation that allows the company to acquire the stock should the child die, divorce, become disabled, or become unable to run the business.

2. Transferring stock without filing a gift tax return, while using book value, can bring a full audit of the company. If this transaction is reviewed, there can be interest and penalties on undervaluation for the stock, as well as additional taxes. This is best avoided by hiring an independent appraiser to establish a value.

3. Even distribution of stock to children who are both active and inactive in the company can be detrimental. If ownership is split evenly between the children, there may be a deadlock on major business decisions and friction among shareholders because of different motivations and understanding of the business. If, on the other hand, the active child is given majority control, the other shareholders will have little say regarding salaries, bonuses, and perks. To prevent these issues, an agreement should be put in place spelling out exactly how critical decisions will be made among shareholders, as well as adding instructions for alleviating voter deadlock.

4. Bequeathing the company to a spouse may seem like a good idea, bypassing estate taxes, but this could lead to control conflicts between the spouse and the active child, as well as even greater estate tax issues upon the spouse's death because of the company's growth in the elapsed time. The best option, in this case, would be for the active child to buy out the stock upon the parent's death, at a reduced rate because of the loss of a key man.

5. Giving real estate on which the business is located to a nonactive family member and the business to the active child often leaves the survivors disagreeing over lease payments for years to come and issues of the property owner's ability to sell the property outside the family. Formulating a lease agreement that stipulates what must be paid and when, and granting the active child the right of first refusal regarding property sales, will smooth many of the future concerns.

6. As Jim tried to divide his estate into assets of "equal value," the issue of business valuation became highly subjective. The simplest way Jim could have prevented Mark and Linda's quarrels would have been to establish a specific dollar amount to bequeath to Linda and update this dollar amount every few years to match the business's current value.

As said, Jim's issues are not unique and would have been easily avoided if he thought seriously about his business succession planning. Don't give your family cause for quarrel or your business cause to fail after you are gone. Consider your options carefully and lay out your solution in detail to prevent any misinterpretations in the future.

Earlier in this article, I mentioned that I would provide several tax-favorable, well-established **strategies** that families have utilized to transfer business interest to family members. The appropriate strategy for any particular family/business will depend on your **goals**, both financial and non-financial, but the following will provide a taste of what may be accomplished.

Sale to a Grantor Trust

Self-Cancelling Installment Note (SCIN)

Grantor Retained Annuity Trust (GRAT)

Sale to a Grantor Trust

A "grantor" trust is a trust in which all taxable trust income is recognized by the grantor (person setting up and funding the trust) as opposed to the trust itself recognizing the tax. As a result, if the grantor sells an asset (like stock in the family business) to the trust, it will not trigger a tax on any gain because the IRS considers that essentially a sale from the grantor to the grantor for income tax purposes—so the transaction is ignored. The trust now holds the stock and uses a portion of the income to make payments back to the grantor to meet their obligations under the terms of the sale.

Once the stock is in the trust and it generates taxable income, the grantor is responsible for paying the tax. This may sound like a bad thing until you realize that by paying the tax on the income the grantor is helping the trust to appreciate at a greater rate. The individuals who will benefit from that tax-free income will be the beneficiaries of the trust who are typically family members/children. So, the grantor has provided an additional economic benefit to his/her heirs without making a gift that is subject to federal gift taxes. This strategy works well for business owners who want to transfer a business to the next generation, avoid gift taxes, retain some level of professional management over the stock, control future distributions, and can't afford—or aren't willing to simply gift—the stock directly to their children.

Self-Cancelling Installment Note (SCIN)

Sometimes, a parent wishes to transfer a business interest to the next generation, but they need to receive some value in return to have sufficient financial means to retire. A typical solution is to sell the business to their children in an installment sale instead of gifting it to them. The children take over the business and pay the sales price (fair market value) over a predetermined number of years with a set interest rate. Any capital gains tax that is triggered by the sale will be stretched out over the life of the note as opposed to being due all in one lump sum.

A twist on the traditional installment sale is the self-canceling installment note (SCIN). The main difference with a SCIN is that should the seller pass away before the note is fully paid off, the note is canceled. The buyer does not have to continue making payments. To avoid being treated as a partial gift, the buyers must either pay a premium for the business (higher sales price) or the installment note must charge a slightly higher than the market interest rate. This strategy works well with family businesses because they need to continue receiving payments when the selling parents pass away.

The Gift to a Grantor Retained Annuity Trust (GRAT)

In a grantor retained annuity trust (GRAT), the grantor gifts ownership in the family business to an irrevocable trust in return for an annuity payment, typically for a term of years. The annuity payment is a fixed amount based on a percentage of the asset transferred and must be paid at least annually. At the end of the term period, the amount remaining in the trust is distributed to the beneficiary chosen by the grantor (the family members taking over the business). The value of the gift on the date of the transfer is equal to the current value of the business interest transferred asset minus the value of the retained annuity interest measured by using the IRS section 7520 rate. For the GRAT to be successful, the rate at which the asset appreciates inside the GRAT needs to be greater than the IRS-assumed rate of growth (IRC section 7520), which at the writing of this book is at a historical low. The tax advantage here is that all of the appreciation in the business that exceeds the 7520 rates is transferred to your children without being subject to gift or estate taxes. So, this strategy is especially effective for businesses that are expected to appreciate substantially in value. Note that should the grantor pass away during the term of the GRAT, the property is brought back into their gross estate and is subject to estate taxes.

Family businesses, just like families themselves, come in many different shapes and sizes and have their unique characteristics. In the remainder of this chapter, I have laid out specific issues that are common with businesses that have similar traits.

One Family *(one child in/one or more out)* Issues

1. The child in business has been given stock with no shareholder agreement and no gift tax return.
2. Exposure to interest and penalties on the undervaluation of the gift.
3. If the child dies, his spouse could become a shareholder, or the subchapter S election could be revoked if the stock is transferred to a nonqualified trust.
4. In the event of a child's divorce, the ex-spouse may be entitled to shares. (Assumes no prenuptial.)
5. Children out of business have been given stock with no shareholder agreement and no gift tax return.
6. See 3, 4 and 5 above
7. If they end up with equal ownership with the active child, it could deadlock the business and cause conflict between the children.
8. If an active child ends up with majority control, then what protection do nonactive children have over how the active child decides on salary, bonus, or perks? He or she could also refuse to distribute the profits necessary to pay the taxes due on the S profits.
9. The owner parent will pass the stock to his spouse instead of an active child.
10. Conflict is possible between an active child and the surviving parent.
11. IRS valuation exposure is enhanced at the second death.
12. The growth of value in business continues in the estate of the spouse.
13. Unless in Q-Tip, there is no guarantee that the active child will receive controlling interest at their parent's demise.
14. If in Q-Tip, a business must be income-producing to the spouse.
15. Owner parent has a redemption agreement with an active child funded with insurance.

If a C corporation is involved, there is no step-up in basis for the child, and due to IRC section 318 (attribution), the redemption could be considered a taxable dividend. If an S corporation is involved, you could get a full step-up in basis in a subchapter S corporation by ending the fiscal year on the date of death. (Note is due.) The insurance proceeds are received in the following year and the remaining shareholders get a full step-up in basis.

1. *Owner-parent leaves business real estate to spouse and business to an active child.*

The conflict could exist over lease payments since it was probably informal before the parent dies. The same issue exists when inactive children are given the business real estate or a controlling interest in the business real estate. In addition, the nonactive children or spouse could sell the real estate to someone other than the active child.

2. *If a second marriage exists and there is no prenuptial.*

The second spouse is entitled to the elective share, which is usually one-third; check your state laws. The higher the value of the business, the more the second spouse receives.

3. *A second death, the active child has left the business while the nonactive children are given assets of equal value. This could result in the same conflict that was mentioned in number 6.*

One Family *(More Than One Child In)* Issues

1. *Most of the issues in the previous section are applicable unless there aren't any inactive children.*

If two children are active, and owner parent leaves stock 50/50. If three are active, it's 33 percent each.

If two children own the stock 50/50, there will be deadlocks unless one child is given voting control or a third individual is given the vote to break a deadlock. If three children own the stock, are decisions made by unanimous decision or majority? If it is unanimous, one child could hold up the business. If it is the majority, two of the children can team up on the other child.

2. *A shareholder agreement exists where there is a buyout of a child's interest by the company (redemption).*

This will result in an increase in the value of the estate by the owner parent due to the redemption of the child's stock if they predecease the parent.

Two Equal Shareholders *(No Children In)* Issues

1. *No shareholders agreement exists.*

Each shareholder could be in a partnership with the spouse or children of the ex-partner. If it is passed to the children and estate taxes are due, the child cannot control the cash flow from the business to meet the estate settlement costs. In addition, if the partner gets divorced, the spouse can end up as a shareholder. Lastly, if the stock is passed into a nonqualified trust, it could revoke the S election.

2. *Unfunded buyout.*

If the deceased shareholder's estate has taxes due, they may not have the cash flow necessary to meet the tax obligations. In addition, this is a nondeductible transaction for the survivor.

3. *A stock redemption agreement exists (first to die).*

If a regular corporation is involved, there is no step-up in basis for the survivor. You could get a full step-up in basis in a subchapter S corporation by ending the fiscal year on the date of death. (Note is due.) The insurance proceeds are received in the following year and the survivor as a 100 percent shareholder gets a full step-up in basis.

4. *A buyout exists for the stock but not for the business real estate.*

Unless a long-term lease exists, significant conflict could exist between the active partner and the spouse of the deceased partner. Also, if estate taxes are due when the real estate is passed to the children, they cannot control the cash flow from the real estate to meet the estate settlement costs.

5. A buyout exists in the event of a permanent disability.

Since this is a lifetime transaction, there will normally be a substantial income tax due to the disabled shareholder. If it is unfunded, the survivor will have a nondeductible buyout.

Two Non-Equal Shareholders *(No Children In)* Issues

1. *No shareholder agreement exists.*

Each shareholder could be in partnership with the spouse or children of the ex-partner. In addition, if the partner gets divorced, the spouse can end up as a shareholder. This is a greater issue for the minority shareholder.

2. *Unfunded buyout.*

If the deceased shareholder's estate has taxes due, they may not have the cash flow necessary to meet the tax obligations. In addition, this is a nondeductible transaction for the survivor.

3. *A stock redemption agreement exists.*

If a regular corporation is involved, there is no step-up in basis for the survivor. You could get a full step-up in basis in a subchapter S corporation by ending the fiscal year on the date of death. (Note is due.) The insurance proceeds are received in the following year and the survivor as a 100 percent shareholder gets a full step-up in basis.

4. *A buyout exists in the event of a permanent disability.*

Since this is a lifetime transaction, there will normally be a substantial income tax due to the disabled shareholder. If it is unfunded, the survivor will have a nondeductible buyout.

5. *A buyout exists.*

If funded with insurance, the majority shareholder is, in essence, buying himself or herself out.

Two Equal Shareholders *(One Family with Child In)* Issues

1. *A buyout exists.*

If the partner with a child in the business dies first, then the child will never be a shareholder and could lose their job. If the other partner dies first, then the survivor's estate is increased by the value of the deceased partner's interest. (Assume it is funded.) The insurance could have been owned by the survivor's child or trust.

2. *No shareholder agreement exists.*

Each shareholder could be in a partnership with the spouse or children of the ex-partner. If it is passed to the children and estate taxes are due, the child cannot control the cash flow from the business to meet the estate settlement costs. In addition, if the partner gets divorced, the spouse can end up as a shareholder. Lastly, if the stock is passed into a nonqualified trust, it could revoke the S election.

3. *Unfunded buyout.*

If the deceased shareholder's estate has taxes due, they may not have the cash flow necessary to meet the tax obligations. In addition, this is a nondeductible buyout for the survivor.

4. *A stock redemption agreement exists.*

If a regular corporation is involved, there is no step-up in basis for the child, and due to section 318 (attribution), the redemption could be considered a taxable dividend. You could get a full step-up in basis in a subchapter S corporation by ending the fiscal year on the date of death. (Note is due.) The insurance proceeds are received in the following year and the child, as a 100 percent shareholder, gets a full step-up in basis.

5. *A buyout exists for the stock but not for the business real estate.*

Unless a long-term lease exists, significant conflict could exist between the active partner and the spouse of the deceased partner. Also, if estate taxes are due when the real estate is passed to the children, they cannot control the cash flow from the real estate to cover the estate settlement costs.

6. *A buyout in the event of a permanent disability.*

Since this is a lifetime transaction, there will normally be a substantial income tax due to the disabled shareholder. If it is unfunded, the survivor will have a nondeductible buyout.

7. *Partner without a child in the business does not want to be partners with the partner's child.*

Partners could structure voting stock being put into a trust at the death of a partner for the benefit of the child in the business. (Survivor is Trustee.) The nonvoting stock could be left outright to a child.

Two Non-Equal Shareholders *(Majority Shareholder Has a Child In)* Issues

1. *No shareholder agreement exists.*

Each shareholder could be in partnership with the spouse or children of their ex-partner. If it is passed to the children and estate taxes are due, the child cannot control the cash flow from the business to meet the estate settlement costs. In addition, if the partner gets divorced, the spouse can end up as a shareholder. Lastly, if the stock is passed into a nonqualified trust, it could revoke the S election.

2. *Unfunded buyout.*

If the deceased shareholder's estate has taxes due, they may not have the cash flow necessary to meet the tax obligations. In addition, this is a nondeductible buyout for the survivor.

3. *A stock redemption agreement exists.*

If a regular corporation is involved, there is no step-up in basis for the survivor. You could get a full step-up in basis in a subchapter S corporation by ending the fiscal year on the date of death. (Note is due.) The insurance proceeds are received in the following year and the survivor, as a 100 percent shareholder, gets a full step-up in basis.

4. *A buyout exists for the stock but not for the business real estate.*

Unless a long-term lease exists, a significant conflict could exist between the active partner and the spouse of the deceased partner. Also, if estate taxes are due when the real estate is passed to the children, they cannot control the cash flow from the real estate to meet the estate settlement costs.

5. *A buyout exists in the event of a permanent disability.*

Since this is a lifetime transaction, there will normally be a substantial income tax due to the disabled shareholder. If it is unfunded, the survivor will have a nondeductible buyout.

6. *A buyout exists in the event of a death.*

If funded with insurance, the majority shareholder is, in essence, buying himself or herself out.

7. *A buyout exists.*

If the partner with a child in the business dies first, his child will never be a shareholder and could be out of a job. If the other partner dies first, the survivor's estate is increased by the value of the deceased partner's interest. (Assume it is funded.) The insurance could have been owned by the survivor's child.

ESTATE PLANNING &
BUSINESS SUCCESSION:

Transfers of a Closely Held
Business to Family

THE LIMINAL
GROUP

Nathan Brinkman • nathan@theliminalgroup.com
theliminalgroup.com • 608-828-4404