

# **CHOICE OF ENTITY/UTILIZATION OF TRUSTS IN ESTATE AND BUSINESS SUCCESSION PLANNING**

## **I. Introduction**

Business Objective and Purposes. In any closely-held corporation, limited liability company or partnership, the ongoing health of the business largely depends on keeping ownership of the business in the hands of those employees and/or family members who actually conduct the business. This is especially true in farm businesses where steps should be taken with respect to the business and estate plan to assure the owners' interest and investment in the business is protected and the interest is passed to the next generation or to the surviving owners with as little difficulty as possible. The objectives to be attained in a farm succession plan are:

1. Minimize income and estate tax impact to both seller and buyer.
2. Establish terms under which plan will operate to avoid need for future negotiations and to give all parties comfort that plan will be implemented.
3. Minimize personal liability and protect assets from third party claimants.

## **II. Choice of Entity**

**Objective: Minimize Estate and Income Taxes, Personal Liability and Protect Assets from Third Parties.**

### **Tax and Non-Tax Considerations in the Selection of a Farm Business Entity**

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Sole Proprietorships	Corporations	General Partnerships
Limited Liability Companies	Limited Liability Partnerships	Limited Partnerships

- A. Sole Proprietorship: A sole proprietorship is a farm owned and operated by a single person. A business certificate may be filed in the county clerk's office if the business is operating under an assumed name. Income of the owner is reported on the taxpayer's 1040, Schedule F.

- Advantages:
1. Very informal operation
  2. No formal requirements to organize

3. Owner makes all decisions without having to be accountable to others
4. No double taxation of an entity - all income reported on owners returns
5. Owner bound by acts of others in entity
6. Ownership interest freely transferable

- Disadvantages:
1. No limitation of liability for owner from contractual or tort liability
  2. Reporting of all income on Schedule F may be disadvantage - i.e., no opportunity to shelter income
  3. Limitation on ability to deduct certain benefits provided to owner and owner's family
  4. Tax liability is at owner's rate. If separate entity utilized could be opportunity to have lower tax rate or to share tax liability with others who have lower tax rate.
  5. Unless preliminary steps are taken, entity disappears upon death of owner

B. General Partnership: A general partnership is an organization which is composed of two or more persons. A partnership can be created without a written agreement. However, it is advisable to have a partnership agreement. A certificate of doing business as partners must be filed in the county clerk's office. Partnerships are not taxed as a separate legal entity. They are "pass through" entities.

- Advantages:
1. Very easy to organize - few formalities, nominal operating costs
  2. Decision making process may be very informal if desired
  3. Detailed statute provides guidance on decisions making and on other matters concerning operation and dissolution if no agreement in place
  4. Pass through tax treatment for owners avoiding double taxation
  5. Entity files Form 1065, not Schedule F
  6. Partnership interests are not freely transferable
  7. May generally be liquidated tax free

- Disadvantages:
1. Unlimited personal liability for owners for acts of entity and acts of partners and employees acting in name of entity
  2. Partnership interests are not freely transferable
  3. Entity dissolves upon occurrence of certain triggering events (death, bankruptcy or withdrawal of a partner)
  4. Any partner may dissolve partnership by withdrawal

5. Each partner may obligate the partnership

C. Corporation: A corporation is a legal "person" that is created by filing of a certificate of incorporation in the Secretary of State's office. A corporation generally has perpetual existence. The owners or shareholders of a corporation have limited liability for the corporation's activities. A corporation is taxed as an entity separate and apart from its owners (unless S status is elected by the entity and its shareholders).

Advantages:

1. Limited liability of owners for tort and contractual liability of entity: liability limited to capital contribution that is utilized for purchase of shares. Exception: wages (New York) and certain taxes (sales/payroll)
2. Owners are not liable for acts of co-owners
3. Entity not terminated upon death, bankruptcy or withdrawal of owners (unless otherwise agreed in writing). Entity's existence may be perpetual
4. Interests (stock ownership) are freely transferable (unless restricted by agreement)
5. Ability to have centralized management. i.e., several owners but board of directors / officers selected to manage day to day operations
6. Ownership interests may be different among owners. i.e., voting/nonvoting interests, preferred/common interests
7. If low profits, C corporation may allow use of lower tax bracket than pass through entity
8. C corporation offers the ability to deduct benefits payable to owners. S corporation's ability is limited, similar to a sole proprietorship
9. Ability to retain profits and avoid taxation at personal level
10. Corporation laws throughout country are very similar and have long history of interpretation

Disadvantages:

1. Certain operating procedures must be followed to avoid piercing of corporate veil and resulting in personal liability for owners (i.e., annual meetings of shareholders, directors; maintenance of corporate minutes etc.)
2. Depending on tax structure (C vs. S) double taxation in operations and upon disposition of assets

D. Limited Liability Company: Effective as of October, 1994, New York State allows the creation of a limited liability company which is a legal entity that offers its

owners protection from personal liability but allows the entity's owners to be taxed as a partnership. An LLC is created by filing "Articles of Organization" with the Secretary of State and entering into an operating agreement. LLCL Section 1203 or by converting a general partnership to an LLC on a tax free basis.

- Advantages:
1. Owners enjoy limited liability for obligations and liabilities of entity and other owners
  2. Pass through entity - avoids double taxation
  3. Flexibility in management and governance. Management may be by members or by managing members (similar to a board of directors)
  4. Ownership interests may be structured in a manner similar to corporation (i.e., voting/nonvoting interests, preferred/common interests)
  5. Common form of business operation internationally

- Disadvantages:
1. Similar to a corporation technical operating requirements must be followed in order to enjoy limited liability and to avoid piercing of the veil
  2. Certain steps must be taken in operating agreement and procedurally in order to avoid dissolution upon death, bankruptcy or withdrawal of an owner/member
  3. May affect eligibility for ASCS/FSA payment programs
  4. Must be careful to avoid unnecessary self-employment tax for those not active in farm.

E. Limited Liability Partnership: A limited liability partnership is a general partnership, the owners of which are protected against tort and contract liability for acts of the other partners or acts of the partnership itself. In New York, LLPs may be composed only of certain professional firms (i.e. architects, accountants, physicians, lawyers, etc.)

F. Limited Partnership: A limited partnership is a partnership which has "general" and "limited" partners. General partners have unlimited liability for the acts of the partners and of the entity. Limited partners are not liable for the acts of the partners or of the entity itself. Taxed as a general partnership (i.e., a "pass through" entity). Limited Partnerships are created upon filing a certificate of limited partnership in the Secretary of State's office.

- Advantages:
1. Offers all advantages of partnership
  2. Allows creation of interests that have limited liability (more

- attractive to investors)
3. Having general and limited partners allows for centralization of management in the hands of the general partners
  4. Flexibility as to allocation of losses and profits among general and limited partners
  5. Limited partner interests are not subject to attachment by creditors - limited to charging order
  6. Ability to transfer equity interests to others while retaining control by general partners
  7. Form of entity may allow for greater valuation discounts to enhance ability to reduce estate values for owners' estate plans
  8. Only general partners may dissolve the partnership

- Disadvantages:
1. General partners are personally liable for farm activities as in a general partnership
  2. Limited partners may not participate in management or they risk loss of protection from liability for acts and obligations of entity and partners
  3. Interests are not freely transferable
  4. More costly to organize than general partnership (filing requirements, publication requirements)

#### Issues to Consider in the Selection of an Entity

1. Taxability of the entity and its owners.
2. Ability of owners to obligate the entity and other owners. Personal liability of the owners for actions and liability of themselves, each others and the entity.
3. Centralization of management within the entity.
4. Transferability of interests in the entity. Ability to restrict transferability by agreement.
5. Perpetual or limited existence of entity.
6. Expense of formation and technical requirements which must be followed in the operation of the entity.
7. Form of ownership interests. e.g., S corporations may not have entities and certain trusts as owners and number of owners is limited (75).
8. Flexibility with respect to allocations of profits and losses of entity.

9. Form of capital contributions being made, equity and nonequity, voting and nonvoting interests being created.
10. Does the entity fit within the owners' estate plans. e.g., only certain trusts may be shareholders of S corporations, may be desire to limit liability of estate for actions of entity etc.
11. What requirements are set forth in the statutes for resolution of shareholder, director disputes? e.g. Ability of a minority shareholder to petition a court for dissolution. May a shareholders or partnership agreement govern instead of statute?
12. Events which may cause or result in dissolution and tax effects of dissolution.
13. Annual or other regular filing requirements are there for the entity? e.g., tax returns, biennial statements with New York State, etc.
14. Need for keeping owners' participation on an anonymous basis.

### **III. The Buy-Sell or Shareholders Agreement**

1. Objective. Specifically agree on how and to whom an ownership interest may be transferred upon the happening of certain stated events.
2. Tax Objectives. In accomplishing the business purposes of a buy-sell agreement, an eye must be kept on the income, gift and estate tax consequences of the agreement. Some of the important tax objectives to be kept in mind are:
  - a. Where desired to cause payments made in a buy-out to be treated as capital gain income. With the top rate on ordinary income now at 38.6% as a result of Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA) and the maximum net capital gains tax fixed at 28%, there is an incentive to achieve capital gains rates (if you are ordinarily in a tax bracket higher than 28%).
  - b. Where possible to cause interest paid on indebtedness incurred to fund a buy-out to be fully deductible under the interest allocation and passive loss rules.
  - c. To provide the remaining or surviving owners with an increase in the cost basis of their ownership interests.

- d. To provide a value for purposes of estate and gift tax planning.
- e. To provide a source of funds with which to pay estate taxes or to generate income for the terminated owner/employee and/or his family.

B. Discounts and Premiums in Determining an Owners Value. In general, any value for a business ownership interest is subject to being discounted because:

1. The interest being valued is a minority ownership interest. The inability to control management and, thus, the earnings of the business provides the basis upon which to apply a minority discount. *See, Ward v. Commissioner*, 87 TC 78 (1986), *Carr v. Commissioner*, 79 T.C.M. 507 (1985) and *Est. of Harrison v. Commissioner*, T.C.M. 1987-134 (1987). Rev. Rul. 93-12 (1993-7.1.R.B.13). But see PLR 9436005 in which the IRS considered the value of stock representing a “Swing Vote.” *See also, Estate of Winkler v. Commissioner*, T.C.M. 1989-232.
2. An interest lacks marketability. *See Folks v. Commissioner*, 43 T.C.M. 427; *Knott v. Commissioner*, 55 T.C.M. 424 (1988), *Colley*, T.C.M. 1980-167.
3. Key man discount where the success of the business is dependent upon a significant individual. *Est. of Rodriguez*, 57 T.C.M. 1033 (1989).

In addition, a farm business owner's interest may be subject to additional value discounts because of either of the following:

- (a) Agricultural use value discount on real estate.
- (b) The need to replace the selling owner's services within the farm operation.

The reciprocal of the minority discount is the ability to clearly control a business. Should there be a premium for shares representing a majority interest? *Est. of Salsbury v. Commissioner*, 34 T.C.M. 1441 (1975).

Question—Can the share price of a minority shareholder be equal in value to the share price of a majority shareholder. Will a Buy-Sell Agreement effectively result in all shares being considered to

be of equal value?

It may be appropriate to use one or more of the above approaches and average or weight the data. If so, why would this be valid?—Isn't value—value?

Discounts have traditionally been applied to farm limited partnership interests and limited liability company interests to accelerate the ability of a taxpayer to reduce his taxable estate by way of a gifting program. Additional consideration should be given to a situation prior to implementing an aggressive gifting program utilizing hefty minority and lack of marketability discounts.

C. Events Which Trigger Operation of a Buy-Sell Agreement.

1. Death. Buy-sell agreements should be triggered by the death of an owner in most cases. In this way the agreement not only provides the surviving owners with an orderly method for transferring ownership and control of the business but it also can operate to provide the decedent's estate with a source of fund to pay death taxes.
2. Disability. A buy-sell agreement may be triggered by the total and permanent disability of an owner. In defining what constitutes disability under the agreement, care should be taken to consider the definition of disability contained in other contracts and agreements of the business (e.g., employee health insurance policies and retirement plans). The client should also be fully aware of when a disability will trigger a buy-out. The nature of the business may be such that just because a shareholder-employee cannot perform his usual functions, he may still be valuable for other services to the corporation. You do not want to force a purchase or a sale when it is not necessary. With a farming operation, the inability to perform one function clearly may not affect the ability to provide other services. For example, if an owner is primarily responsible for dairy operations, an injury may prevent him or her from continuing in that capacity. However, the farmer may be of equal value in performing cropping operations for the farm. Many standard buy-sell agreements state that disability is the inability of the owner to perform his or her duties as historically performed. Such a definition could trigger a buy-out of an owner when the remaining owners wish to retain the services of the disabled owner in another capacity. This unintended result can be avoided by use of a carefully crafted definition of disability that limits the disability to

the inability to perform any useful functions for the farm.

You may have an entity where some shareholders are employees and some are not. In this case, make sure that both classes of owners are treated in the manner they desire. The employee owner may or may not need to be bought out depending on his or her needs. Also, when drafting keep in mind the other documents to which the corporation is bound. Failure to properly link the definition in the agreement to that contained in other instruments may cause unintended results where other agreements become operative but the buy-sell agreement does not.

3. Retirement. Almost all buy-sell agreements are triggered by the retirement of an owner/employee and can be used to provide a source of retirement income. But, the age of retirement should be specifically set forth in the agreement. As discussed below, other agreements can be used in combination with the buy-sell agreement to provide retirement income to the senior generation.
4. Termination of Employment. A buy-sell agreement may be triggered on termination of employment in order to permit owners to voluntarily leave the farm. In addition, a buy-out could be triggered when employment is terminated by the farm for cause (e.g., dishonesty, insubordination, breach of some other agreement). A voluntary termination (by the employee) and an involuntary termination (for cause) may be treated differently. For example, if an employee-owner leaves, there may be penalties or vesting schedules that may be applicable.
5. Divorce. A buy-sell agreement may be triggered on the divorce of an employee/ owner in order to prevent a transfer of an ownership interest to a former spouse in a property settlement and the creation of a new, potentially disruptive owner. A divorce should be expressly stated as a triggering event since the courts have not interpreted general restrictions on lifetime transfers contained in a buy-sell agreement to cover the situation of divorce. It is rare that a court will order the transfer of an ownership interest in a closely held business to a spouse, but having such a provision protects against an unexpected result.
6. Insolvency. A buy-sell agreement may be triggered on the insolvency of an owner in order to try and prevent a transfer of an ownership interest by operation of law to a bankruptcy trustee or receiver. Such a representative may be difficult to deal with in the operation of the business. This triggering event can be used to

backstop a permitted pledge of the ownership interest as collateral for a loan or a source of credit. The buy-out would be triggered upon a default in the loan or credit agreement and would permit the interest to be purchased under either a cross-purchase, redemption or hybrid approach but not by the outside creditor.

Some farm operations provide that a junior owner's interest may be subject to purchase if the person's credit worthiness deteriorates. Many farm succession plans depend on the ability of the next generation to purchase the interest of the current owners. If the owners are unable to borrow funds or if their participation in borrowing funds with others results in higher costs of borrowing, this can have an adverse effect on the ability to purchase the farm and to obtain operating capital for the farm operation.

7. Flexible Triggers. A buy-sell agreement may provide for an exception to a triggering event, such as death, in order to allow stock of the corporation to pass by will or gift to a family member already involved in the business. This prevents a portion of the family from being excluded from the business because of a buy-out.

For example, if two brothers have a traditional buy-sell agreement that provides for a buy-out of a brother upon death, that agreement could terminate the deceased brother's family from continuing in the farm.

8. Tag Along. A buy-sell agreement may also be triggered with respect to a spousal or minority interest when an outside purchaser acquires the ownership interest of a majority owner. These so-called tag along or piggy back provisions help assure a market for a minority interest. Frequently, a spousal or minority interest is warranted in furtherance of an estate plan. In such cases, the owner may not be involved in the operation of the business and triggering the acquisition of that interest on the sale of the owner/ employee's interest is appropriate.
9. Right of First Refusal. It is appropriate to have a provision in the agreement that prohibits a shareholder from selling his stock without first granting the remaining owners or the business the opportunity to acquire the interest. Therefore, if one of the owners wishes to sell their interest, he or she would notify the other owners of his or her intention to sell and the other owners would have a reasonable period of time to acquire the withdrawing owner's interest. The purchase price under a right of first refusal

(whether or not exercised) should be determined pursuant to the terms of the buy-sell agreement in order to preserve the agreement's ability to fix the value of ownership interests for estate and gift tax purposes.

D. Method of Funding a Buy-Sell Agreement.

1. Life Insurance. Life insurance is the most popular method chosen to fund payment of the purchase price in the event of death. However, in the event of a life-time sale under a buy-sell agreement, only the cash surrender value of a policy would be available under the insurance contract. In addition, the obligation to pay premiums in order to maintain a policy depletes any funds otherwise available to pay the purchase price in a lifetime sale. When considering use of life insurance to fund payment of a purchase price, the following factors should be taken into account:
  - (a) Under a cross-purchase, redemption or hybrid agreement, the amount paid as premiums will not be deductible.
  - (b) Generally, receipt of the proceeds upon the death of the insured is not taxed as income to the beneficiary, unless there is a transfer for value problem.
    - (1) A transfer for value problem can arise where the initial owner of the life insurance policy transfers or sells the policy to someone other than the insured (or a partnership or corporation in which he has an interest). For instance, where an owner/employee terminates employment and the policy insuring the life of the withdrawing owner is sold to his spouse. Upon the insured's death the insurance proceeds received by the spouse (less the purchase price paid for the policy and any premiums paid by the spouse) will be taxed as ordinary income to him or her.
    - (2) Receipt of the insurance proceeds by a regular (or "C") corporation under a redemption agreement may cause the corporation to be subject to, or increase the corporation's liability for, the alternative minimum tax. This is because insurance proceeds may increase "book income" and one-half of book income over the corporation's alternative minimum taxable income (before taking book income into account) is treated as a tax preference. There are

current proposals before Congress to eliminate the corporate AMT.

- (c) In a redemption agreement, the valuation formulae generally excludes any insurance proceeds from the computation of the purchase price. This appears appropriate since in a cross-purchase agreement, the insurance would not be owned by the entity and therefore not included in the valuation. Cash values may be included in the valuation where the triggering event is not death.
- (d) In order to avoid including both the amount of insurance proceeds and the value of the ownership interest in the estate of an insured owner, the insurance proceeds should not be paid directly to the estate of the deceased owner.
  - (1) The insurance policy can be collaterally assigned to either an escrow agent or trustee in order to guaranty the availability of the proceeds to pay the purchase price.
  - (2) In a cross-purchase agreement, a collateral assignment to an escrow, trust or partnership will not prevent the purchasing owners from being treated as having paid the purchase price in order to obtain an increase in the cost basis of their entire (old and new) ownership interest.
  - (3) Insurance proceeds paid by reason of the death of a "controlling" shareholder pose special problems. Care should be taken to avoid the proceeds from being considered an asset of the corporation and an asset of the insured's estate.
- (e) Initially the insurance purchased to fund a buy-sell agreement may be adequate but as the value of the business increases the insurance may become inadequate. Therefore, the amount of insurance should be periodically reviewed.
  - (1) A buy-sell agreement should provide for the event of inadequate insurance proceeds by requiring the balance of the purchase price, after payment of the insurance proceeds to the seller, be amortized pursuant to a promissory note. The note need not be for as long a term as in the case of a note given to

finance the purchase of the entire interest since the excess price over available proceeds will be smaller.

- (2) Because of the cumbersome number of policies that may exist in a cross-purchase format provisions to insure adequate coverage may be difficult.

However, frequently special programs can be established for the maintenance of insurance to fund cross-purchase agreements, such as:

- (i) First to die insurance;
  - (ii) The formation of a trust or partnership to own all policies.
- (f) A buy-sell agreement should prevent disputes regarding proceeds in excess of the purchase price by expressly providing how any excess proceeds are to be handled. A possible use for the excess proceeds may be to fund a deferred compensation agreement for the benefit of a deceased owner's spouse. If nothing is stated to the contrary in the agreement, the "excess" proceeds will belong to the beneficiary of the policy.
- (g) A buy-sell agreement may provide that if an owner sells the interest in the farm to the other owners, other than by reason of death, the entity may (but is not required to) sell the life insurance policy on the withdrawing owner to him or her.
  - (1) There should be no transfer for value problem if the policy is sold to the insured at its fair market value.
  - (2) A mere option to allow the insured to purchase the policy for its fair market value generally may constitute an "incident of ownership" which would result in the inclusion of the insurance proceeds in the insured's gross estate upon the death when he or she dies still owning an interest in the enterprise. See to the contrary, however, Est. of Smith, 73 TC 307 (1979). (The IRS acquiesced to the result not the Court's reasoning. 1981-1 CB 1). Compare First National Bank of Birmingham v. US, 1964-2 USTC ¶12, 252 (No Ga 1964), revd 358 F.2d 625

(5th Cir. 1966).

3. Disability Buy-Out Insurance. A disability buy-out can be difficult to fund where the disabled owner is a key employee responsible for generating most, if not all, of the profits of the business. Disability buy-out insurance can be purchased, but it is often quite expensive. Unlike a life insurance policy, a disability buy-out policy typically does not pay out in a lump sum, but over a period of years (e.g., five years) after a waiting period (e.g., one or two years).
  
4. Debt Financing. The purchase price under a buy-sell agreement can be paid by either giving the withdrawing owner, or deceased owner's estate, a cash down- payment and a long-term promissory note for the balance of the purchase price or by the borrowing funds necessary to pay the purchase price. A promissory note does not need to be (but generally is) for a stated number of years. It should bear a reasonable and adequate rate of interest. The IRS publishes monthly tables indicating adequate rates of interest for debt obligations. Where interest is below the rate required by the IRS, or if an adequate rate of interest is stated but interest is not paid currently, a portion of the principal amount of the note will be recharacterized as interest. The rate of interest may be fixed or variable and payments of principal and interest under the note could be required on a monthly or annual basis. The note may also provide for payment of not less than a certain dollar amount in order to avoid financing a nominal amount over a long period. If this form of note is used, the term of the note becomes variable. There are several other issues which should be considered in the provisions of the buy-sell agreement concerning the use of a promissory note.
  - (A) Security.
    - (1) In most instances a note given as payment for an ownership interest will be secured by a pledge of the ownership interest.
    - (2) The pledged interest may be held in escrow or in trust.
    - (3) The note may also be secured by a personal or corporate guarantee.
    - (4) In a cross-purchase agreement where one note is given to the deceased or withdrawing owner, the

obligation to pay the note may involve several remaining owners. In such a circumstance, it may be appropriate that the obligation to pay be both joint and several among the remaining owners.

- (5) The note may also be secured by the business assets of the corporation or partnership, or other assets of the obligor.
- (B) Subordination. When a promissory note is given as payment for the purchase price established under a buy-sell agreement and the note is secured by a pledge of the business assets, the note should state whether it is or will be subordinate to any subsequent debt incurred with respect to the pledged assets. If the note is not to be subordinated, the ability of the farm to borrow against those assets to finance working capital may be severally restricted. As an alternative to unlimited subordination, the note may provide that it is subordinate only on the borrowers' default on certain bank loans or only to certain loans from institutional lenders. The note may also contain affirmative covenants that prevent:
- (1) The creation of any security interest in favor of other owners;
  - (2) The declaration of dividends or increases in employee salaries unless a specific amount is maintained as a reserve; or
  - (3) Require the maintenance of certain financial ratios (i.e., debt to equity).
- (C) Default and Acceleration. The circumstances under which the obligor may be considered in default may include failure to make a timely payment under the terms of a note, but might also include impairments to the collateral securing the note or the breach of an affirmative covenant such as discussed above. Similarly, it is generally appropriate to require acceleration should the obligor "sell out" by the sale of substantially all the corporate assets, merger, or the same of more than 50% of the stock of the corporation by the remaining shareholders.

Default might cause payments made prior to the default to

be treated as dividend distributions if the default causes the stock pledged as security to be returned to the withdrawn shareholder. It may be possible to prevent dividend treatment by prohibiting the purchase by the secured party, thus requiring the "foreclosures" sale to be made to a third party.

A default, as well as certain other occurrences, generally triggers acceleration of the remaining balance of the note, as well as the interest thereon.

- (D) **Bank Financing.** Another alternative to financing payment of a lifetime or death sale is for the purchaser to borrow the funds from a bank or other lending institution and pay the purchase price in full. To facilitate financing for this purpose a buy-sell agreement's general prohibition to pledging the ownership interest as collateral should provide an exception for financing the purchase price under the agreement, but require that in the event of a default, the collateral is to be purchased by the remaining owners in order to satisfy the bank debt. In this way, foreclosure will not cause the interests to be sold to individuals not connected with the business or family.
- (E) **Deduction of Interest.** The deductibility of interest paid on debt incurred or given to pay for the purchase of an ownership interest is subject to the new interest allocation and passive loss rules enacted by the Tax Reform Act of 1986. The allocations rules are complex and the IRS is in the process of issuing final regulations on how the rules should work. However, there are currently many unanswered questions as to how the rules work when a redemption agreement is used by an S corporation or partnership. While a complete discussion of these rules is beyond the scope of this outline. Presently existing regulations and guidance generally provide that interest:
  - (1) Paid or accrued by closely-held corporation (50% or more of the stock is owned by five or fewer shareholders) in a redemption agreement will generally be treated as portfolio interest (investment interest) which is deductible against active trade or business income or passive activity income.
  - (2) Paid or accrued by S shareholder or partner in a

cross-purchase agreement will generally be treated as non-passive interest deductible against all types of income if the only assets of the S corporation or partnership are used in a trade or business (other than a rental activity) and the S shareholder or partner materially participates in such trade or business. If he (they) do not materially participate, or only a rental business is conducted, then the interest will be passive interest, generally deductible only against passive income.

If the assets of the corporation or partnership are not rental property but are only held for investment and not used to conduct a trade or business, then the interest will be investment interest and deductible only to the extent of investment income.

- (F) **Multiple Purchases.** The financial ability of a purchaser under either a redemption or cross-purchase agreement to pay the purchase price is usually limited. If multiple purchases are required in a relatively short period of time, such as the death of an owner followed by retirement of another. To prevent such a burden on the purchaser and to help assure sufficient cash flow, a buy-sell agreement may provide that in the event more than one owner is to be bought-out:
- (1) Payment of the purchase price is to proceed in the order the triggering events occurred, or
  - (2) Regardless of how many purchases are to be made at once under the agreement, the maximum amount paid towards all purchases is capped at some annual amount, with the maximum payment split among the deceased or withdrawing owners equally, or pro rata based on price.

The obligor may not have the financial ability to amortize the purchase price and still remain competitive or financially sound.

#### **IV. Other Agreements.**

In implementing a farm succession plan it may be appropriate to utilize other documentation to provide retirement income to senior owners, to provide benefits,

including incentive benefits to key employees and to establish a tax favorable means for passing the farm to the next generation whether family or non-family. These agreements may include the following:

1. Noncompetition Agreements. Once a former owner/employee has resold their interest in a non-farm business back to the entity or other owners, it is a common practice for the business and remaining owners to want to protect themselves from competition with the former owner or their divulgence of confidential business information or secrets. Thus, a noncompetition agreement may be included in the terms of the buy-sell agreement. However, in a farm business, a noncompetition agreement is not necessarily advantageous because the payments are deductible over 15 years and are taxed at ordinary income tax rates for the recipient.
3. Deferred Compensation Agreements. It is not unusual to provide a reasonable amount of compensation to the withdrawing shareholder/employee or partner/employee in the form of a nonqualified deferred compensation agreement. Payments under a deferred compensation plan may be subject to FICA if not properly structured.
4. Consulting Agreements. Similar in tax substance to "4" above. However, consulting agreement payments will be subject to self-employment tax in any event.

## V. Use of Trusts in Succession Plan.

**Objective: Minimize estate taxes, asset protection, equalization of estates among farm and non-farm heirs, preserving farm assets for successive generations.**

- a. Insurance Trust. In cases where estate taxes are to be paid (state and/or federal), an insurance trust can be utilized to provide cash to family members with which estate taxes may be paid.

Insurance trusts are also an excellent way to achieve equalization of an estate among business and non-business siblings. If a significant portion of an estate is comprised of business assets, the business children will more than likely not want to share business decision making responsibilities or benefits with their siblings. Insurance policies within a trust can satisfy the parents' desires to provide for non-business children without adversely affecting the business.

Insurance premiums can be paid through gifts from the father (utilizing the annual exclusion) or the premiums may be paid by the Corporation under a split-dollar arrangement.

- b. Irrevocable Trust. Use of an irrevocable trust can provide the family with several benefits. Assets held in trust are not subject to creditor or spousal claims. Therefore, a trust may be appropriate where the older generation wants to be assured that stock or other business interests transferred to the next generation are not subject to third party claims. A trust may also be advantageous when a business owner would like to begin a succession plan but he or she is not certain as to which of his children may be interested in the business or capable of operating the business. In such a case, the trust may be drafted so that when the shares are to be distributed they are distributed only to those beneficiaries who are involved in the business. As described above, other arrangements can be made for those beneficiaries of the trust who are not in the business. A trust allows a grantor to retain greater control over the disposition of the shares than if the stock or other business interests are gifted outright.

A trust can also be used as a purchaser even in the case where there are only two owners. If the surviving owner has a trust purchase the interest that interest will not be in his taxable estate if the trust is properly structured and it will not be subject to his creditors. The trust can hold the interest for the benefit of the remaining owners family.

## **VI. The Qualified Family Owned Business Interest Deduction (QFOBI) - What's It Really Worth?**

**CAUTION: The QFOBI Deduction will be repealed for any deaths after December 31, 2003. However, the recapture provisions discussed below will continue beyond 2003.**

- A. QFOBI (IRC Section 2057) - IRC Section 2057 contains the Qualified Family Owned Business Interest deduction known as the QFOBI. Section 2057 was enacted under the 1998 Tax Act and essentially recast the QFOBI rules originally enacted under Section 2033A of the 1997 Act as a deduction rather than an exclusion. Section 2057 corrected some of the problems that arose under prior Section 2033A.

The QFOBI offers significant planning opportunities for closely held business enterprises. Farms can especially benefit from the proper planning and utilization of the QFOBI because it is very common for farms to be multi-generational within

the family line. However, whether a farm or any other closely held enterprise is involved, careful attention must be given to plan for the complex requirements of the QFOBI to ensure maximum benefits are realized.

B. Qualification Requirements. An estate must meet all of the following requirements to qualify for the QFOBI deduction:

1. Decedent must have been a citizen or resident of the United States at death.
2. The executor must elect to utilize the QFOBI deduction. Advisors should familiarize themselves with Schedule T of Form 706 where the executor will make the election.
3. A written agreement must be signed by all beneficiaries who received QFOBI property (and essentially must agree to be responsible for the recapture tax).
4. The value of the QFOBI property must be greater than 50% of the decedent's gross estate.

Tip: Premortem planning is important to ensure that the decedent meets these requirements. Advisors should be familiar with the following rules:

- a. Lifetime gifts made by the decedent to qualified heirs is included. This is good because it allows the advisor to continue a gifting program with the client.
- b. If the decedent holds QFOBI property in more than one business, all of the interest are aggregated.
- c. If the decedent transfers non-QFOBI property to other than his spouse or family members within three years of death on a non-taxable basis, the assets must be bought back in as part of the denominator in calculating the 50% test. Although this may appear to be detrimental on the surface, a planning opportunity is evident in that advice should be given to transfer non-QFOBI assets to a trust or directly to family members.
- d. The decedent or members of the decedent's family must have owned and materially participated in the business' operating for 5 out of the 8 years preceding the date of death.
- e. Qualified heirs will be subject to a recapture tax is they do not materially participate in the business for at least 5 years out of any

8 year period within 10 years following the decedent's death. If the qualified heir disposes of the business interest, a recapture tax plus interest will be amended based on the following schedule:

<u>Year Following Death</u>	<u>Recapture Tax</u>
1-6	100%
7	80%
8	60%
9	40%
10	20%

The recapture tax is a personal liability of the qualified heir to the extent of his portion of the tax savings realized on the QFOBI property received. Remember - they signed an agreement. As noted above, the recapture provisions survive the repeal in 2004.

C. Planning Suggestions.

1. Annual exclusion gifts of non-QFOBI assets should be made to family members and family trusts to ensure estates will meet the 50% test. Consider removing all insurance policies from estate, including term and group term policies.
2. Marital deduction formulas in wills and in revocable trusts should be modified to direct the executor or trustee to utilize the QFOBI deduction.
3. QFOBI assets should not pass to a marital trust because the deduction will be lost.
4. As stated above, give careful consideration as to the extent to which the QFOBI will be utilized. The restrictions on past-death ownership evidence that it may be advisable to utilize exemption equivalent to the extent available rather than the QFOBI deduction.