

**Liquidity Planning for the Closely- Held
Business Owner: A Case Study**

By:

Keith R. Fevurly, JD, LLM, MBA, CFP®
Visiting Instructor in Finance
Metropolitan State College of Denver

Presented to:

Academy of Financial Services
Annual Meeting
Anaheim, California
October 9-10, 2009

Abstract

The creation of liquidity has long been an issue for large taxable estates, particularly those that consist primarily of a closely held (non-publicly traded) business interest. This issue is further complicated by those businesses operating as a Subchapter S corporation under the provisions of the Internal Revenue Code, which includes numerous restrictions about the number and type of qualifying shareholders.

This paper includes a case study of a fictitious 50 per cent shareholder, Mr. John Bigbox, currently serving as the CEO of a regionally-based closely held retail electronics store, Optimal Electronics, organized initially as an S corporation and currently operating in that form. The remaining 50 percent shareholder, Mr. Ben Nichols, is also involved in the business and is the logical successor owner to the more elderly Mr. Bigbox. Among the estate planning goals of Mr. Bigbox is to efficiently transfer his business interest at death to Ben Nichols, while also creating liquidity for a reasonably comfortable anticipated retirement for Mr. Bigbox and his wife. Other goals of Mr. Bigbox include providing for the future financial health of his wife and daughter and creating a market for his otherwise limited marketable closely held business interest.

Among the possible solutions suggested for Mr. Bigbox are the funding of a cross-purchase business continuation agreement with Ben Nichols, the creation of an employee stock ownership plan (ESOP) for the business, the sale of the Bigbox business interest using a self-canceling installment note (SCIN) or private annuity, and the payment of estate taxes due in a tax-favorable manner.

Liquidity Planning for the Closely- Held Business Owner: A Case Study

Introduction and Case Scenario

With the inclusion of the extension of the federal estate tax for those taxable estates in excess of \$3.5 million in the 2010 Budget, as proposed by the Obama administration, it becomes an imperative for the closely held business to engage in effective estate planning, most specifically, liquidity planning so as to prevent the sale of a closely held business interest at a significant discount to its appraised fair market value at the business owner's death. Moreover, it is very likely that such interest will be subject to tax at an effectively flat rate of 45 per cent, since the total gross estate of the business owner will be substantially in excess of the applicable credit amount for the year 2009 (\$3.5 million) and beyond.

Fortunately, there are multiple solutions to the liquidity planning challenge facing the closely held business owner, both prior to the owner's death, and, if certain statutory requirements are met, for the owner's estate, subsequent to his or her death. It is the purpose of this paper to present and analyze the efficacy of those solutions in the context of a typical fact pattern. Therefore, consider the fact situation of Mr. John Bigbox, age 67, the 50% owner of a successful, regionally based electronics store, Optimal Electronics, who has consulted with you, a CFP® certificant planner, to address the issue of business succession and estate planning for his closely-held business and family.

Personal and family situation: Mr. Bigbox is married to Ms. Jane Bigbox, age 65, and they have one daughter, Laura, age 33, who is married and lives out-of-state. Mr. Bigbox is currently in good health, but has a history of congenital heart disease in his family. Laura has no interest in the future operation of Optimal Electronics, although would like to continue to see it prosper, both for her own and her mother's future financial health. The current appraised fair market value of the business (in the year 2009) is \$20.0 million, with Mr. Bigbox's 50 per interest valued at \$10.0 million before any valuation discounts. Mr.

Bigbox's simple will leaves his 50 per cent interest in the business equally to his spouse, Jane, and daughter, Laura. Your quick, "back-of-the-envelope" estate tax computation indicates that, if Mr. Bigbox were to die in the year 2009, the amount of estate tax due on the business interest alone would be \$675,000.

Company Information: Optimal Electronics is operated as a Subchapter S corporation (S corporation) with a current appraised fair market value of \$20.0 million. There are two shareholders of the business, each with a 50 per cent ownership, Mr. Bigbox and a younger employee-protégé, Mr. Benjamin (Ben) Nichols, age 45. The business has done well financially in recent years and has a strong balance sheet and free cash flow. This is expected to continue, although business has declined somewhat over the last 12 months due to the recession experienced in the region where the business is located. The owners of Optimal Electronics have been pre-occupied with the growth of the business and have accumulated significant retained earnings within the business entity. They would now like to share their past success with the 80 employees of the business. The business currently does not have either a profit-sharing or pension plan of any kind.

Goals and Objectives of Mr. John Bigbox: (not in any order of priority)

- 1) To effectively provide for the ownership succession of his 50 per cent interest in Optimal Electronics at his death to Ben Nichols and continue the business as a "going concern".
- 2) To effectively provide for the future financial health of both his wife, Jane, and daughter, Laura, at his death.
- 3) To ensure that there is sufficient liquidity for John and Jane to enjoy a reasonable comfortable retirement in a time-frame of three to five years from now; they anticipate a retirement period of 15-20 years.
- 4) To plan his estate in the most tax-efficient manner possible, including taking advantage of any possible liquidity elections that are available to a closely held business owner.

Possible Solution #1: Implementation of a Cross-Purchase Business Continuation Agreement and Split-Dollar ILIT Funding

In the case of corporate entities, such as Optimal Electronics, the most common type of business continuation agreements (also known as "buy-sell agreements") are: 1) entity redemption plans and 2) shareholder cross-purchase plans. The distinguishing characteristic of the entity redemption plan is that the corporation (or, here, Optimal Electronics) agrees to purchase (or redeem) the stock of the retiring or deceased shareholder. Alternatively, in a cross-purchase plan, the shareholders agree among themselves to purchase the interest of the retiring or deceased shareholder at the date of

the terminating event. The purchase of a life insurance policy (ies) to fund the agreement is often used to fund the agreement.

The provisions of the business continuation agreement will generally establish (or “freeze”) the value of the business for federal estate tax purposes if:

- 1) the agreement is a bona fide business arrangement;
- 2) the agreement is not a device to transfer such business interest to the member’s of the decedent’s family for less than full and adequate consideration in money or money’s worth; and
- 3) the terms of the agreement are comparable to similar arrangements entered into by persons in an arm’s length transaction.

See Internal Revenue Code (IRC Section 2703 (b)). However, in the situation under consideration, Mr. Bigbox and Ben Nichols are unrelated shareholders (non-family members), thus, establishing a priori that the presumption of an “arm’s length transaction”, as mandated by statutory requirements to establish a fair value, is met.

A requirement to maintain the S corporation tax status is that such corporation may not have more than one class of stock at any one time throughout its operation. If a second class of stock is created, the corporation is disqualified from the S corporation election, with the subsequent loss of so-called “pass through tax treatment”. In an effort to avoid such disadvantageous tax consequences as these, it is likely that Mr. Bigbox should favor implementation of the cross-purchase form of business continuation agreement to dispose of his interest in Optimal Electronics at his death. Moreover, a more practical reason for the cross-purchase form is the fact that any life insurance owned by Optimal Electronics (in the entity redemption alternative) is constructively paid for with shareholder dollars and not from the individual shareholder’s own funds. There are also tax basis consequences with respect to the shareholder’s interest from the receipt of the

life insurance proceeds by the corporation. Specifically, if the S corporation has previously accumulated corporate earnings and profits (as has Optimal Electronics), the receipt of the insurance proceeds may impact the amount that the corporation can distribute to the shareholders (Mr. Bigbox and John Nichols) without dividend attribution treatment.

Under a typical cross-purchase business continuation agreement, each purchasing shareholder receives an increased cost basis in the shares purchased from the selling shareholder. See IRC Section 1012. This is generally not possible with an entity redemption agreement funded by life insurance since the insurance policies constitute a corporate asset and not that of the individual shareholder. (Note that, whereas the receipt of the insurance proceeds in the entity redemption form may increase the value of the stock owned by each shareholder for federal estate tax purposes, this is far from the complete step-up in basis experienced by the shareholders in the cross-purchase alternative.) The increased basis afforded the purchasing shareholder (here, Ben Nichols) may not be vitally important if he intends to hold the stock acquired from the selling shareholder (here, Mr. Bigbox) until his subsequent death, however, it does provide flexibility for the purchaser with respect to his own estate planning. For example, should Ben Nichols choose to retire and sell his now, total interest in Optimal Electronics, a substantial capital gains tax savings would likely accrue.

Finally, using the cross-purchase form of business continuation agreement, Ben Nichols will purchase the 50 per cent interest of Mr. Bigbox and use the life insurance proceeds to purchase the inherited interest of Jane and Laura Bigbox. However, under the “incidents of ownership rules” of IRC Section 2042(2), Ben has added to his taxable estate by the corresponding purchase of life insurance necessary to buy-out the Bigbox family, thus adding to his own estate tax problem. How to solve this dilemma? Both Ben

and Mr. Bigbox (in the unlikely event that he should die first) should draft and implement an irrevocable life insurance trust (ILIT) to purchase and own the life insurance policy on each other's life. The value of each policy would be equal to each owner's proportional interest in the business or, here, approximately \$10 million. Moreover, the arrangement should be funded with a permanent form of split-dollar life insurance policy, such as a whole life or universal life policy, that can be endorsed with a charge to each business owner to cover the cost of the premium obligations under the arrangement.

In practical terms, the ownership of the life insurance policies by the respective ILITs, and their use in purchasing the interest of Mr. Bigbox at his death by Ben Nichols, would work like this. Each owner's trust would purchase a life insurance policy on each other's life. The cross-purchase agreement would then provide that a portion or all of the death proceeds payable could be "rented" from either Mr. Bigbox or Ben Nichols to satisfy their respective premium obligation. The value of this charge would be equal to the economic benefit cost of providing this death benefit (actuarially, only a fraction of the premium, although the cost would be greater for Ben Nichols since the premium is higher for Mr. Bigbox as the older individual). If the buy-sell agreement is terminated during the lifetime of either Ben Nichols or Mr. Bigbox, the owner continues to have access to the policy and its cash value to supplement any retirement income or to buy out the other at that time. Additionally, the policy may be retained by either Ben Nichols or Mr. Bigbox to assist with payment of estate taxes due, but without the inclusion of the death proceeds in his taxable estate. (You should note that, under the split-dollar final regulations, the economic benefit amounts received by each owner—here, Ben Nichols and/or Mr. Bigbox—are taxable as ordinary income, but each should likely consider this as the price to be paid for the inherent lifetime flexibility provided by the split-dollar funding and policy death benefit exclusion provided by the ILIT planning technique.)

Possible Solution #2: Sale of Bigbox Interest to ESOP During Lifetime

As noted, among Mr. Bigbox's estate and financial planning objectives is to ensure that there is sufficient liquidity for his and Jane's anticipated retirement. However, since the majority of estate value is in his very illiquid (and relatively non-marketable) business interest in Optimal Electronics, it is beneficial for John to consider establishing an entity to which his interest could be sold. Fortunately, the law provides for such an entity known as an employee stock ownership plan (or "ESOP").

An ESOP is a defined contribution retirement plan designed to invest primarily in employer securities. See IRC Section 4975 (e) (7). Since the ESOP entity or trust is separate from the company (here, Optimal Electronics), a sale to the entity is not considered to be a redemption under corporate tax law, and the rules for qualification as a redemption to take advantage of preferential capital gains rates do not apply. Moreover, per IRC Section 409 (h) (2) (B), an ESOP established by an S corporation is not required to grant participants the right to receive distributions in the form of employer stock (a normal ESOP tax qualification requirement), provided that distributions will otherwise be made in cash or a cash equivalent to the fair market value of the stock. Accordingly, presuming adequate free cash flow is generated over future years by Optimal Electronics to compensate the participants, Mr. Bigbox has converted an illiquid asset (his stock ownership in the company) to a liquid asset (cash) that may be used to meet his retirement goals.

There are also benefits that accrue to Optimal Electronic because of the structuring of the ESOP. The first of these benefits is one of capital structure. Specifically, an ESOP (the Plan) is the only type of qualified retirement plan that is permitted to borrow funds in its own name without contravention of the IRC Section

4975 prohibited transaction rules. Financial leverage thus occurs, potentially increasing the shareholders expected rate of return on their investment. The second of these benefits is tax-related and increases the cash flow of the corporation. A contribution of the percentage of stock owned by Mr. Bigbox generates a tax deduction for Optimal Electronics equal to the stock's fair market value at the time of contribution. See IRC Section 404(k). In turn, the significant deduction increases the cash flow available to the corporation. Generally, an employer can deduct a contribution to an ESOP of up to 25 per cent of the total compensation paid to all participants in the plan. See IRC Section 404(a) (9) (C). However, in the case of an ESOP that uses leverage, this aggregate percentage limitation includes not only interest payable on the loan used by the Plan to acquire employer securities, but also any *principal* payments due and owing on the loan. The corporation is also permitted to deduct the amount of cash dividends paid on shares of stock held by the ESOP if those dividends are passed through to the plan participants.

Finally, should Mr. Bigbox and Ben Nichols so choose, how could the creation of the ESOP assist in carrying out the cross-purchase buy-sell agreement also under consideration? An alternative to the purchase of life insurance by their respective ILITs on the lives of Mr. Bigbox and Ben Nichols is to, instead, have the trustee of the ESOP secure such policies. This insurance should be owned by the ESOP as "key person life insurance", since the Plan does indeed possess an insurable interest in the lives of the two business principals. At the death of Mr. Bigbox, the trustee would collect the insurance proceeds from Ben (as the beneficiary of Mr. Bigbox's policy) and use the money to purchase the stock from the Bigbox estate. The stock would then be reallocated to the plan participants, with Ben's account likely receiving the majority of the stock over time. The remaining stock would be allocated to the other plan participants.

Possible Solution #3: Sale of Bigbox Interest to Ben Nichols using a SCIN or Private Annuity

An alternative solution to Mr. Bigbox's need for liquidity as a part of his retirement planning is the lifetime sale of his 50 percent interest in Optimal Electronics to Ben Nichols. This sale could take the form of either a self-canceling installment note (or "SCIN") or a private annuity. The SCIN is a variation of the installment sale of a business interest wherein a provision is included in the installment note that extinguishes the obligation of the purchaser (here, Ben Nichols) at the death of the seller (here, Mr. Bigbox). If the installment note ends by its terms, and within the seller's actuarial life expectancy at the time that the note is executed, the transaction will be treated as an installment sale. This means that, to the benefit of Mr. Bigbox, the note could be secured by the value of his business interest. However, since the possibility of Mr. Bigbox's premature death impacts the present value of the note, the IRS takes the position that a taxable gift may result unless the purchaser (Ben Nichols) pays a premium to compensate for the self-canceling feature of the note. If he does, the value of the SCIN in the Bigbox estate will be *zero*, since no additional payments are remaining at the seller's death. See Revenue Ruling 86-72, 1986-1 C.B. 253.

In the event that Mr. Bigbox dies before all the payments due him under the SCIN have been paid, the unrealized gain from the sale of his business interest will be triggered as "income in respect of a decedent" (IRD) on the Bigbox estate tax return (IRS Form 706). See IRC Section 691 (a) (5) (iii). As a practical matter, this means that there is double taxation of the gain—once for estate tax purposes and the second for income tax purposes (since, as IRD, the inherent gain in the note is not eligible for the step-up in basis that is normally accorded to assets included in the gross estate). Nonetheless, the estate's income tax return (IRS Form 1041) is permitted a deduction for the estate tax

paid and attributable to the inclusion of the IRD. See IRC 691 (c) (1) (B). The purpose of this deduction is to provide at least some mitigating relief of the double taxation consequence of IRD items.

Still another solution to the liquidity challenge posed by the ownership of Mr. Bigbox's substantial closely held business interest is to enter into a private annuity transaction with Ben Nichols. Such a transaction would consist of a sale of the Bigbox stock to Ben in exchange for a fixed, monthly annuity payment payable to Mr. Bigbox, also perhaps continuing to Mrs. Bigbox for her life at his death. For Mr. Bigbox, the greatest advantage to this transaction is in reducing, or at least "freezing", the size of his estate. Like the SCIN, if the stock transferred was valued fairly at the time of the transaction, the annuity payments (if structured for a single lifetime payout only) would end at the death of Mr. Bigbox, thus resulting in no taxable value in his estate. Moreover, there is no gain triggered at the death of the annuitant, as would be the result with the SCIN alternative. However, these advantages are coupled with a distinct disadvantage: the promise of the payment to the annuitant in a private annuity must remain unfunded and unsecured; that is, Bigbox must rely on the mere promise of a payment by Ben Nichols. This may be more of a risk than Mr. Bigbox is willing to assume; particularly, given his financial objectives of a comfortable retirement lifestyle and providing for the future financial health of his wife and daughter.

So, which might be preferable for Mr. Bigbox and the sale of his business interest to Ben as a lifetime transaction? The SCIN or the private annuity? Admittedly, both the private annuity and SCIN have the potential to reduce the Bigbox estate value; but the SCIN is likely preferable for several primary reasons:

- 1) The obligation of payment from Ben to Bigbox may be adequately secured without the negative income tax consequences to Bigbox arising from the private annuity transaction;
- 2) The payments made under the SCIN are finite in number (established under the terms of the installment note), regardless of Mr. Bigbox's life expectancy; and
- 3) The purchaser of the interest under the SCIN (here, Ben Nichols) may get a deduction for the interest paid under the income tax investment rules. This is limited only by the amount of net investment income reported by Ben on his annual IRS Form 1040. See Revenue Ruling 93-68, 1993-2 C.B. 72.

Possible Solution #4: Payment of Estate Taxes as part of a Corporate Redemption or in Installments over Time

Finally, assume for the moment that Mr. Bigbox pursues *no* estate planning in addition to what he has already done; that is, write a simple last will and testament providing for the disposition of his business interest to his wife and daughter equally. What happens then? Are there are post-death liquidity elections that may be available to his estate to assist with payment of a substantial estate tax obligation? The answer to this question is, Yes, there are two such elections: 1) a section in the Tax Code, IRC Section 303, available only to business interests conducted in an incorporated form; and 2) a second possible election taking advantage of the right to pay estate taxes due in installments as found in IRC Section 6166. Since these elections are not mutually exclusive, presuming that the Bigbox estate satisfies the qualifying requirements of each section, both may be used to assist in payment of the estate taxes due without the necessity of a forced sale of Bigbox's stock interest.

Per the normal rules of corporate income taxation, any distribution to a shareholder is a taxable dividend unless there is some stated exception in the Tax Code.

See IRC Section 301. IRC Section 303, Distributions in Redemption of Stock to Pay Death Taxes, is just such an exception. If Section 303 is applicable, the stock redeemed by the estate is treated as the sale or exchange of a capital asset. Thus, since the stock is typically entitled to a step-up in basis by virtue of being included in the decedent's gross estate, there should be little, if any taxable gain accruing to the estate. See IRC Section 1014 for the step-up in basis rules. Therefore, in a Section 303 redemption, the liquidity of the corporation (versus the illiquidity of the shareholder's closely-held business interest) may be accessed to assist in the payment of the estate tax.

There are seven basic requirements that must be met to take advantage of the Section 303 redemption-of-stock provisions (one of which, that the election is available only to incorporated business interests, has already been mentioned). Among the remaining requirements are likely the two most important: 1) that the stock of the corporation owned by the decedent must exceed 35 percent of the decedent's adjusted gross estate at his or her death; and 2) that the distribution must be in redemption of part or all of the stock of the corporation. While the value of the Mr. Bigbox's adjusted gross estate (the gross estate minus debts and expenses of the decedent) is uncertain from the facts given, it is very likely that the majority of his estate assets consist of the Optimal Electronics stock interest and, thus, his estate should have no problem in meeting the 35 percent threshold. Further, there are only two shareholders in Optimal Electronics, thus, the redemption of a "part of the stock of the corporation" is clear. The reward for meeting the Section 303 qualifying requirements is that the sum of any estate taxes due imposed on the Bigbox estate, plus any funeral and administration expenses pertaining to the estate, may be paid with a redemption of stock equal to these equivalent amounts. See IRC Section 303 (a).

Like IRC Section 303, IRC Section 6166, Extension of Time for Payment of Estate Tax Where Estate Consists Largely of Interest in Closely Held Business, is structured to assist with the payment of estate taxes on a small business interest. But, unlike the 303 requirements, Section 6166 applies to *all* closely-held business, including unincorporated and incorporated businesses. The interest in the closely-held business must also have a value in the decedent's gross estate of more than 35 percent of the adjusted gross estate and the decedent must be "actively involved" in the activities of the entity at his death. See Revenue Ruling 75-365, 1975-2 C.B. 471. The executor of the estate must also elect the benefits of the section no later than the due date of the U.S. Federal Estate and Generation Skipping Tax Return, IRS Form 706; generally, no more than nine months after the decedent's date of death. If Section 6166 is applicable, the Bigbox estate is afforded the right to elect to pay all or part of the estate tax otherwise due in no more than ten equal installments and to receive preferential interest charges on the deferred amounts. Moreover, the first installment of the principal due may be delayed for a period of up to five years after the due date of the return.

Summary

This paper has considered the estate planning scenario of Mr. John Bigbox, his wife, Jane, and his daughter, Laura. Several lifetime planning alternatives and two-post death alternatives have been presented. Whereas the Internal Revenue Code, Treasury Regulations, and relevant IRS Revenue Rulings do permit several post-death liquidity elections to be made by the Bigbox estate executor, the making of these elections do not assist in meeting the lifetime goals of Mr. Bigbox and his family, notably the assurance of liquidity for a reasonably comfortable retirement lifestyle. Rather, in addition to the drafting and funding of a cross-purchase business continuation agreement to ensure the financial health of Bigbox's heirs subsequent to his death, Bigbox should also consider

establishing an ESOP to provide a lifetime market for the sale of his business interest or separately entering into a self-canceling installment note (SCIN) with the other shareholder of Optimal Electronics, Benjamin Nichols.