



**Select Portfolio  
Management, Inc.**

David M. Jones, MBA  
Wealth Advisor  
120 Vantis, Suite 430  
Aliso Viejo, CA 92656  
949-975-7900  
dave.jones@selectportfolio.com  
www.selectportfolio.com

# Family Business Succession Planning

Wealth Management is more than just portfolio management. It encompasses a disciplined professional approach to growing, protecting, preserving, utilizing, and transferring your wealth, using a broad range of services and an experienced team of advisors.

Please feel free to contact me if you have any questions about this article and how it may pertain to your situation. You can also visit our website, [www.selectportfolio.com](http://www.selectportfolio.com), anytime to find other useful articles and information.

If you are within 10 years of retirement, let me help you understand how the retirement landscape has changed and how these changes can impact your current and future financial decisions.



## Transferring Your Family Business



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

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

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

### You and your estate may get some relief under the Internal Revenue Code

If you are prepared to begin transferring some of your business interest to your beneficiaries, a systematic gifting program can help accomplish this while minimizing the gift tax liability that might otherwise be incurred. This is done by utilizing your ability to gift up to \$12,000 per year per recipient without incurring gift tax. By transferring portions of your business in this manner, over time you may manage to transfer a significant portion of your business free from gift tax. Clearly, the disadvantage of relying solely on this method of transferring your business is the amount of time necessary to complete the transfer of your entire estate.

In addition, Section 6166 of the Internal Revenue Code allows any estate taxes incurred because of the inclusion of a closely held business in your estate to be deferred for 5 years (with interest-only payments for the first four years and interest plus principal due in the fifth year), and then paid in annual installments over a period of up to 10 years.

This allows your beneficiaries more time to raise sufficient funds or obtain more favorable interest rates. The business must exceed 35 percent of your gross estate and must meet other requirements to qualify.

### Selling your business interest outright

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

### Transferring your business interest with a buy-sell agreement

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

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

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

***There are many estate planning tools you can use to transfer your business. Selecting the right one will depend on whether you plan to retire from the business or keep it until you die.***

## Grantor retained annuity trusts or grantor retained unitrusts

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



## Private annuities

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

Until very recently, exchanging property for an unsecured private annuity allowed you to spread out any gain realized, deferring capital gains tax. Proposed regulations have effectively eliminated this benefit for most exchanges, however. If you're considering a private annuity, be sure to talk to a tax professional.

*A more sophisticated business succession tool is a grantor retained annuity trust (GRAT) or a grantor retained unitrust (GRUT).*

## Self-canceling installment notes

A self-canceling installment note (SCIN) allows you to transfer the business to the buyer in exchange for a promissory note. The buyer must make a series of payments to you under that note. A provision in the note states that at your death, the remaining payments will be canceled. SCINs provide for a lifetime income stream and avoidance of gift tax and estate tax similar to private annuities. Unlike private annuities, SCINs give you a security interest in the transferred business.

## Family limited partnerships

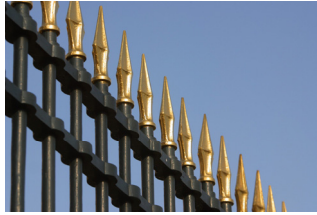
A family limited partnership can also assist in transferring your business interest to family members. First, you establish a partnership with both general and limited partnership interests. Then, you transfer the business to this partnership. You retain the general partnership interest for yourself, allowing you to maintain control over the day-to-day operation of the business. Over time, you gift the limited partnership interest to family members. The value of the gifts may be eligible for valuation discounts as a minority interest and for lack of marketability. If so, you may successfully transfer much of your business to your heirs at significant transfer tax savings.



## Grantor Retained Annuity Trust (GRAT)

### Definition

A grantor retained annuity trust (GRAT) is an irrevocable trust into which a grantor makes a one-time transfer of property, and in which the grantor retains the right to receive a fixed amount of principal and interest



at least annually for a specified term of years. At the end of the retained interest period or upon the death of the grantor, whichever is earlier, the property remaining in the trust passes to the remainder beneficiaries or remains in trust for their benefit.

A transfer of property to an irrevocable trust is a taxable gift. The value of the gift on which gift tax is imposed is generally its fair market value. However, because the grantor retains an interest in a GRAT, the value of the transfer is discounted; gift tax is imposed only on the remainder interest (and any gift tax due may be sheltered by the grantor's \$1 million lifetime gift tax exemption).

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

### For a GRAT to be successful:

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

### Potential tax advantages of a GRAT include:

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

### Key tradeoffs

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

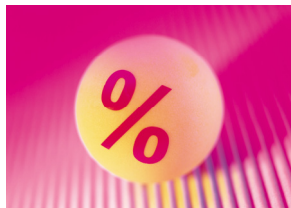
### How is it implemented?

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

## Grantor Retained Unitrust (GRUT)

### Definition

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



A transfer of property to an irrevocable trust is a taxable gift. The value of the gift on which gift tax is imposed is generally its fair market value. However, because the grantor retains an interest in a GRUT, the value of the transfer is discounted; gift tax is imposed only on the remainder interest (and any gift tax due may be sheltered by the grantor's \$1 million lifetime gift tax exemption).

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

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

### For a GRUT to be successful:

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

### Potential tax advantages of a GRUT include:

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

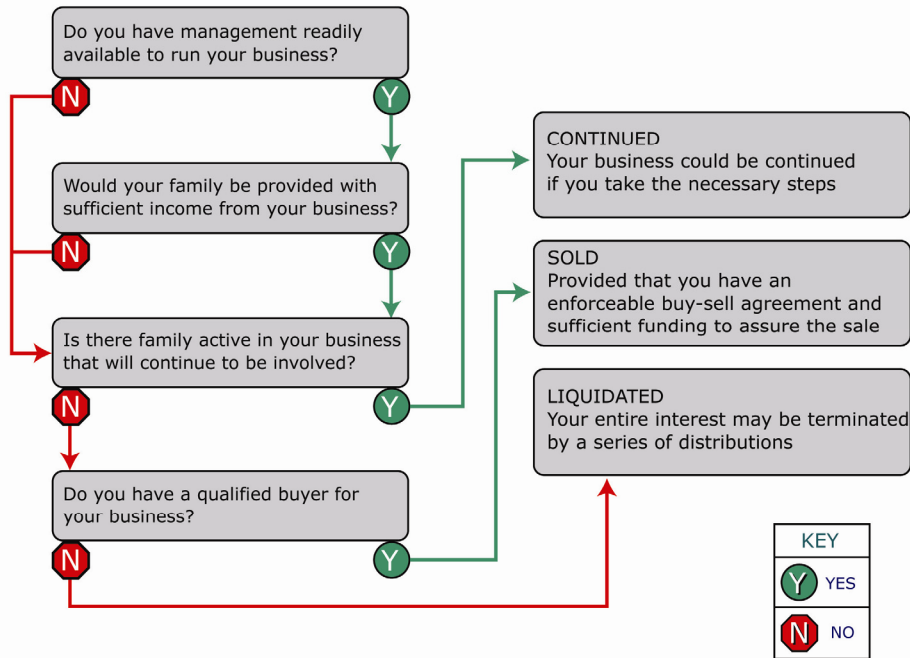
### Key tradeoffs

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

### How is it implemented?

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

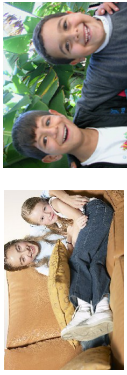
## Planning for Succession of a Business Interest



## Business Succession Planning Alternatives

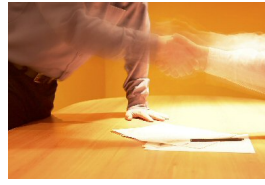
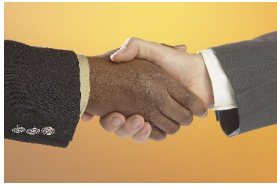
	Lifetime Gifts	Bequest	Lifetime Sale	Estate Sale	Buy-Sell Agreement
<b>If you want to:</b> <b>Sell your business interest</b>	Not appropriate	Not appropriate	You may be able to sell your business outright-but there is no guarantee	Your estate may be able to sell your business outright-but there is no guarantee	Buy-sell agreement can be used to guarantee the sale of your business
<b>If you want to:</b> <b>Give business to your children</b>	You can control the timing and size of the gifts	You control the size of the gift through your will	Not appropriate	Not appropriate	Not appropriate
<b>If you want to:</b> <b>Sell business to your children</b>	Can be used in conjunction with sale	Not appropriate	You can control timing of sale-but sale is not guaranteed	Your child could buy from your estate-but sale is not guaranteed	Buy-sell can be used to guarantee your child's option to buy your interest
<b>If you want to:</b> <b>Minimize value of your estate</b>	Can be used to reduce the value of your estate and maximize gift tax exclusion	Will not minimize value of your estate	You can control timing of sale-but sale is not guaranteed	Value of business must be included in your estate	Value of business must be included in your estate, but the buy-sell can help establish that value

# Select Options for Preserving a Family Business for Children



	Family Limited Partnership	Private Annuity	Self-Canceling Installment Note	Grantor Retained Annuity Trust	Lifetime Gifts
<b>Provides liquidity?</b>	No	Yes	Yes	Yes	No
<b>Minimizes federal gift tax?</b>	<ul style="list-style-type: none"> <li>To the extent of the annual gift tax exclusion and the lifetime gift tax exemption</li> <li>Value of gifts may be discounted</li> </ul>	Yes, to the extent the fair value of the business does not exceed the present value of the annuity	Generally, yes	Yes, to the extent the fair value of the business does not exceed the present value of the annuity	To the extent of the annual gift tax exclusion and the lifetime gift tax exemption
<b>Minimizes federal estate tax?</b>	Shifts future appreciation to children	Yes, but not to the extent payments are received back into your estate	Yes, but not to the extent payments are received back into your estate	Yes, but not to the extent payments are received back into your estate	Shifts future appreciation to children
<b>Minimizes federal income tax?</b>	Shifts FLP income to children, who may be in lower tax brackets	<ul style="list-style-type: none"> <li>Generally, payments are return of basis and/or interest (ordinary income)</li> <li>You pay income tax on interest income</li> </ul>	<ul style="list-style-type: none"> <li>Payments are return of basis, capital gain, and/or interest (ordinary income)</li> <li>You pay income tax on interest income</li> </ul>	<ul style="list-style-type: none"> <li>You pay no income tax on annuity payments</li> <li>You pay taxes on all income earned by the trust</li> </ul>	Yes
<b>Minimizes federal capital gains tax?</b>	Yes, but children do not receive a "step up" in cost basis for gifted interests	No, generally, for exchanges made after October 18, 2006	Capital gain can be reported over the period payments are received	Yes, but children do not receive a "step up" in cost basis	Yes, but children do not receive a "step up" in cost basis
<b>Lets you retain control of the business?</b>	Yes	No	No	Yes	No
<b>Provides lifetime income?</b>	To extent you receive FLP income	Yes	Yes	Yes	No
<b>Protection against creditors?</b>	<ul style="list-style-type: none"> <li>Yes, if general partner is a corporation</li> <li>Limited partners have no personal liability for business debts</li> </ul>	Payments received are subject to creditors	Payments received are subject to creditors	Payments received are subject to creditors	<ul style="list-style-type: none"> <li>Your creditors cannot reach gifted interests</li> <li>Gifted interests are subject to your children's creditors</li> </ul>
<b>Any risk?</b>	No	<ul style="list-style-type: none"> <li>You may die before receiving full payment</li> <li>The buyer's obligation is unsecured</li> </ul>	You may die before receiving full payment	No	No
<b>Formalities?</b>	Many	<ul style="list-style-type: none"> <li>Transfer title</li> <li>Execute agreement</li> </ul>	<ul style="list-style-type: none"> <li>Transfer title</li> <li>Execute note</li> </ul>	<ul style="list-style-type: none"> <li>Transfer title</li> <li>Execute trust</li> </ul>	Transfer title
<b>Costly?</b>	Yes	Can be costly	Can be costly	Can be costly	No

## Overview of Buy-Sell Agreement Forms



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





**Select Portfolio  
Management, Inc.**

David M. Jones, MBA  
Wealth Advisor  
120 Vantis, Suite 430  
Aliso Viejo, CA 92656  
949-975-7900  
dave.jones@selectportfolio.com  
www.selectportfolio.com

This material does not constitute the rendering of investment, legal, tax or insurance advice or services. It is intended for informational use only and is not a substitute for investment, legal, tax, and insurance advice.

State, national and international laws vary, as do individual circumstances; so always consult a qualified investment advisor, attorney, CPA, or insurance agent on all investment, legal, tax, or insurance matters.

The effectiveness of any of the strategies described will depend on your individual situation and on a number of other factors. After reviewing your personal situation, we may recommend that you not use any strategy in this document but instead consider various other strategies available through our practice.

Please feel free to contact me to discuss your particular situation.

Securities offered through Securities Equity Group, Member FINRA, SIPC & MSRB

David M. Jones is a Registered Representative. CA Insurance # 0E65326